IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

HANNA NICKEL SMELTING COMPANY, a corporation, and THE HANNA MINING COMPANY, a corporation,

Appellees.

HANNA NICKEL SMELTING COMPANY, a corporation, and THE HANNA MINING COMPANY, a corporation,

Cross-Appellants,

vs.

UNITED STATES OF AMERICA,

Cross-Appellee.

On Appeal from the United States District Court
for the District of Oregon

HONORABLE GUS J. SOLOMON, Judge

APPELLEES' ANSWERING BRIEF
AND
BRIEF ON CROSS APPEAL

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OTHER AUTHORITIES

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No. 21,232

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APPELLEES' ANSWERING BRIEF

STATEMENT OF JURISDICTION

Appellees (collectively called "Hanna") adopt the Government's statement of the jurisdiction of the District Court and of this Court (Gov Br 1-2).

STATEMENT OF THE CASE

I. Introduction[1]

As indicated in the Government's brief (at 2-11; see R

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[1] The statement which follows is believed to be sufficient for the Court's consideration of the questions presented by the Government's appeal. However, a more complete statement of the facts, with appropriate citations to the record, is set forth in Appendix C hereto, pp 97-108 below.

215-217), there was during the Korean War an acute shortage of nickel for critical defense needs, and no domestic source of supply Hanna[2] owned the only known U.S. deposit, but the process for refining its particular chemical composition into useful ferro-nickel[3] was experimental and had not been proved out in a pilot plant. The urgency was such that the Government insisted on assuming the risk of by-passing the pilot plant stage and contracte with Hanna as follows: (1) The Government would buy enough nickel ore, at a fixed price, to produce a minimum of 95 million and a maximum of 125 million pounds of nickel in ferro-nickel; (2) the Government would lend Hanna up to $22 million in the form of capita advances (plus necessary working capital) to build and operate a full scale smelter, which the Government would take over in cancellation of the loan if the process proved not feasible; and (3) if the process proved feasible, Hanna would produce and sell 95-125 million pounds of nickel to the Government at Hanna's cost of production, plus the number of cents per pound (applicable to the first 95 million pounds) sufficient to amortize and repay the $22 million smelter loan with interest.

The process was made to work; the Government acquired 108 million pounds of nickel; all of its loans for facilities and

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2. The term "Hanna" includes Hanna Nickel Smelting Company and The Hanna Mining Company which was joined as an additional defendant on a guarantee in a related contract. Defendants are referred to collectively as "Hanna" for purposes of simplification.

3. Ferro-nickel produced from this ore consists of approximately 45% nickel and 55% iron. See Pl Ex 85, p 200 and Def Ex 98, p 1. It is used primarily in the manufacture of stainless steel.

working capital plus interest having then been repaid, Hanna took clear title to the smelter by making a residual payment as provided in the contract in the negotiated amount of $1.7 million. Thereafter Hanna bought out its obligation to deliver the remaining 17 million pounds by paying to the Government $2,175,000.[4]

4. The question of the profitability of the contractual arrangement, which the Government concedes to be irrelevant to the issues below and here (Gov Br 11), was intentionally avoided on the trial (Oct Tr 124, 125; July Tr 226), and for that reason the record does not contain a definitive exhibit showing the economic effect of the transaction as a whole. However, the Government's extensive and prejudicial references in its brief (Gov Br 3, 8, 9, 10, 11) to the profitability of the transaction to Hanna justify and require the assembling of such evidence as the record does contain on the economics of the whole transaction from the Government's standpoint, as follows:

   The Government purchased 107,686,000 pounds of nickel (105,500,000 as of March 31, 1961 and 2,186,000 pounds thereafter, R 298, 299) for a total outlay of $98,329,000 (capital advances of $22,300,000 plus working capital advances of $69,945,000 (R 298), plus interest of $4,799,000 on these advances (Def Ex 77, G and I), plus $1,285,000 for 2,186,000 pounds purchased after March 31, 1961 at 58.77¢ per pound (R 298, 299)). During the period 1955-1957 the Government resold to industrial users 30,341,000 pounds of Hanna nickel for a total of $35,792,000 (Def Ex 82, p 20), or an average of $1.18 per pound, leaving it with 77,345,000 pounds and an unrecovered outlay of $62,537,000. From this remaining outlay must be deducted Hanna's residual payment of $1,722,000 in respect of the smelter and its payment of $2,175,000 to buy out its remaining obligation to deliver 17,314,000 pounds of nickel which the Government did not need (R 298, 299; Def Ex 98, p 2), leaving a total net Government outlay of $58,640,000 for the remaining quantity of 77,345,000 pounds, or 75.8¢ per pound.

   The market price of nickel in ferro-nickel per pound (f.o.b. Riddle, Oregon, subject to reduction for freight equalization with that from Port Colborne, Ontario -- approximately 3¢ per pound to Eastern markets) at the date of the final termination of DMP-50 on March 5, 1964, was 75 1/4¢, and in recent months has been 82 3/4¢, as published in American Metal Market. That Hanna should have made a substantial profit while providing the Government with 77,345,000 pounds of nickel for a net remaining Government outlay per pound, at the final termination of the contract, in the vicinity of the market price, proves only that a commercial nickel deposit is a very valuable property. No one has yet suggested that Hanna was under obligation to make its nickel available to the Government at less than market value.

Toward the conclusion of the contract, during the Gover ment's 1961 audit of Hanna's 1960 costs, a dispute had arisen and was being negotiated between Hanna and the Government over the propriety of Hanna's charging items costing $210,605 to cost of production, and the Government made a claim on Hanna for a refund of that amount, expressly on the ground that the charges were not properly part of cost of production under generally accepted accounting principles (Def Ex 125). During nine years of contrac performance, no doubt had entered anyone's mind that this was the standard to be applied, as attested by unbroken record references (see pp 30-33 below).

Before negotiations over the $210,605 claim were conclu came the widely-publicized investigation by a subcommittee of the Senate Armed Services Committee of the Government's stock-piling program, including the Hanna contracts (see R 261-266). This was naturally followed by a GSA reaudit of DMP-50 -- the smelting contract -- (although it had been thoroughly audited annually by GSA during performance) and the submission by the Government to Hanna thereafter of a claim for $1,739,328 based on the 284 items of expenditure on which this suit was subsequently filed (R 211; Pl Ex 61). The Government claimed that these items were improperly expensed and charged to cost of production and should have been, but were not, capitalized and made the subject of capital advances under the contract.

The Government appears to have recognized from this time forward, however, the great difficulty of sustaining any suc disallowances under the previously applied standard of generally accepted accounting practice, and the consequent necessity of

somehow constructing a different theory and standard.

Its position has suffered ever since from the discomfort that so often attends the necessity to evolve and defend theories that are in essence after-thoughts which do not correspond to what governed the action of the parties during the transaction: Inconsistencies develop, which require further modification, which develop further inconsistencies, and so on.

The first Government position that emerged to justify the original challenge of 284 items in this suit was that the contract contains its own accounting standard and that the words "cost of production" in the price provision of the contract exclude all "replacements or improvements," because, it said, all replacements and improvements (not just those that are capitalizable under generally accepted accounting practice) are eligible for capital financing under Article VI(1). It followed, in the Government's new view, that "generally accepted accounting practices may not be employed to decide whether replacements or improvements are cost of production." (July Tr 5)

But this simplistic theory had to be modified, among other reasons, to accommodate as part of "cost of production" the replacement of items such as light bulbs and, finally, of any other items, some of them costing as much as $20,000 to 40,000 each (e.g., Items 114, 171, 172, 263/274, P1 Ex 90); and at the second trial the Government, on the advice of its own accounting witness, Dr. Wright, abandoned $346,222 of its claim relating to 68 replacements or improvements that he conceded were properly charged to cost of production (R 334, 378; July Tr 7, 37). But if some "replacements or improvements"

are properly charged to cost of production, why not others, and where and how is the line to be drawn -- if not by reference to generally accepted accounting standards?

So a more complicated further modification of the Government's theory emerged, which has to some extent survived, making involved distinctions between "items," "components," and "improvements" (Gov Br 43-44; see July Tr 48-50), based only remotely, if at all, on the language of the contract and retreating from time to time to the alternative offered by Dr. Wright's testimony, that the result of this so-called contractual standard in any event differed very little from the conclusions that he would reach based on generally accepted accounting principles (July Tr 37-38, 41; Gov Br 18, 77-81).

Now, however, the Government is confronted with the trial court's acceptance of the overwhelming weight of the expert testimony of four of the nation's most eminent accountants to the effect that (1) this contract, unlike other Government forms, does not provide its own set of cost accounting standards; (2) by reason of its ambiguity in this respect, recourse to generally accepted accounting practice is necessary; and (3) applying such practice, Hanna's accounting was correct (except that Judge Solomon disallowed charges to cost of production amounting to $231,506, which are not in dispute on this appeal and which, it should be noted, involved principally the items -- costing $210,605 -- that were under negotiation between the parties in early 1962, before this dispute arose).[5]

So now we are faced in the Government's brief with a

5. Compare Exh B to Def Ex 77 with Pl Ex 82, Items 131, 107/12 and 130.

still further adjustment of position which for the first time suggests the following theory: Even though the parties may have contemplated that cost of production would be determined in accordance with generally accepted accounting practice, the testimony of Hanna's accounting witnesses is wide of the mark, and the court below erred in relying on it, because from time to time these witnesses spoke of generally accepted accounting practice as applied in the smelting industry (Gov Br 78-81) -- this in the teeth of the fact that DMP-50 is a smelting contract and the record makes clear that generally accepted accounting practice cannot be divorced from the practical facts of the business to which it applies.

2. Summary Statement of the Case

Under a contract executed January 16, 1953 with the Government, a nickel smelter was developed and operated in Oregon by Hanna Nickel Smelting Company. The contract ("DMP-50") was one of three related contracts between Defense Materials Procurement Agency (DMPA) and subsidiaries of The M. A. Hanna Company under the Defense Production Act of 1950 (R 215-217).

Contract DMP-50 provided that Hanna, with money advanced by the Government, would construct and operate a smelting facility using an experimental French refining process. Hanna agreed to purchase nickel ore from the Government (for the price the Government paid to The Hanna Mining Company for the ore under Contract DMP-49,

under which Hanna Mining opened and developed its nickel bearing ore deposit), to process the ore and to deliver the product up to 125,000,000 pounds of contained nickel in ferro-nickel to the Government by June 30, 1962 (R 216; Def Ex 82, pp 13-14).

The funds advanced by the Government for construction and operation of the smelter were to be repaid by delivery to the Government of the smelter's product -- ferro-nickel -- at a price which was to be credited against the advances. The contract provided for two kinds of advances: (a) Capital Advances, on which there was a ceiling and Government approval was required for expenditures, and (b) Working Capital Advances, on which there was also a ceiling, and which operated as a revolving fund to finance the cost of production (Article VI). The contract provide for two corresponding elements in the price of each pound of nicke produced: (a) an amortization factor, calculated to repay capital advances over the first 95,000,000 pounds of nickel produced, and (b) a cost-of-production factor (on which there was also a ceilin arrived at by prorating, over the pounds of nickel produced, non-capital costs which had been financed in the first instance by working capital advances (Article VIII). This litigation arises out of a dispute over the cost-of-production factor.

The contract continued in force from 1953 to 1964 with various amendments. After initial construction and experimentation, the smelting process eventually proved technically feasible. By 1958 the smelter was producing at an annual rate of over 20,000,000 pounds of nickel (Def Ex 82, pp 16-17). The important national purpose of DMP-50 and the related contracts wa

fulfilled: The Government acquired a firm domestic supply of nickel (Def Ex 82, p 4). Despite the difficulties inherent in a crash program (July Tr 218A), Hanna admittedly did everything it could to reduce production costs payable by the Government (Oct Tr 94, 196; Pl Ex 93; Def Ex 30, 10/9/58 at p 2, 12/9/58 at p 2) and, as a result, the Government's total net outlay for Hanna's stockpile nickel was and is in the vicinity of or below its market price (fn 4 above; Def Ex 98, p 2).

Between 1953 and 1961 the Government made, in the aggregate, capital advances to Hanna of $22,300,000 and working capital advances of $69,945,000. As of April, 1961 all of these advances had been repaid with interest, and 105.5 million pounds of nickel had been delivered to the Government (R 298; Pl Ex 87, 88). As above indicated, the amount of those advances determined the price of the nickel, and the method of repayment was by crediting the price of the nickel against them. At this point Amendment 5 to the contract was negotiated by the parties -- whereby Hanna made to the Government the above-described residual payment of $1.7 million to discharge the mortgage on the smelter; a lower ceiling price (58.77¢ per pound) was established on the remaining 19.5 million pounds of nickel, and the delivery schedule on this nickel was extended (R 217, 298-299; Pl Ex 59). By 1964, an additional 2.2 million pounds had been delivered (R 299; Pl Ex 21), the market price of nickel was higher than the contract ceiling price and the Government did not desire further nickel for the stockpile (Def Ex 98, p 2). Accordingly, by negotiated agreement Hanna paid the Government $2,175,000 to release the

obligation to deliver the balance (R 299, Pl Ex 3).

In this action, the Government contends that 216 items (out of 284 items originally contended for) in the total amount of $1,392,377 -- roughly 2% in value of the thousands of items which were treated as costs of production -- should instead have been capitalized and treated under the capital advance route. The principal issue is whether Hanna's accounting treatment of these items as expense rather than capital was proper. This issue turns essentially on whether (a) the contract has self-contained cost accounting standards which require capitalization of additions, modifications, replacements or improvements of the smelter -- as the Government contends; or (b) the applicable standard for capitalizing or expensing is generally accepted accounting practice -- as Hanna contends and as the trial court held.

On this principal issue, the District Court found (the two opinions of the District Court are reported at 253 F Supp 784) that the contract does not present a self-contained accounting system, that its provisions as to what is to be expensed and what capitalized are ambiguous, and that it is necessary to look to generally accepted accounting practice. The court further found that under generally accepted accounting practice the company's accounting treatment of 178 items, amounting to $1,160,871, was proper; and that as to 38 items, amounting to $231,506, its accounting treatment was not proper (R 382-389, 465-466). (On these appeals, the court's decision as to the $231,506 is not challenged.)

The Government in its appeal challenges the rejection of its claim as to the $1,160,871, contending that the contract contains

its own cost accounting standards, under which the items were required to be capitalized; and, alternatively, that if generally accepted accounting practice governs, the expert evidence showed that under such practice most of the items were required to be capitalized.

The District Court also held, alternatively, that estoppel barred the Government from asserting its claim as to the part of the $1,160,871 expended after 1957 -- because the Government through its auditors knew of the accounting practices now in dispute but failed to protest at any time, leading Hanna to continue using the practices and to increase its exposure (R 390-395). In its appeal the Government challenges this alternative holding.

Separately, the Government sought reformation of the 1961 amendment to the contract (which fixed a new ceiling price of 58.77¢ per pound for the remaining 19.5 million pounds of nickel) -- on the theory that the amendment employed an "agreed formula" based on the difference between Hanna's costs of production in 1959 and 1960, and that hence the amendment should now be "reformed" to reflect the 1959 and 1960 costs as changed by eliminating items of those years to the extent successfully challenged in the main claim. The District Court agreed with the Government's reformation theory, and applied it to reflect 1959 and 1960 costs of production after eliminating the items held to have been improperly expensed in those years. On this basis the court awarded the Government $241,798 on its reformation claim (R 395-396, 466-467).[6] In its

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6. Since the Government's main claim on appeal includes certain 1959 and 1960 expenditures, the Government contends that it will be entitled to an additional $7,800 by way of reformation if its appeal is sustained with respect to those expenditures (Gov Br 46-47).

cross-appeal, Hanna challenges this award in toto, contending that there was no factual or legal basis for reformation to reflect an agreed formula rather than the agreed figure.

Additionally, the District Court awarded prejudgment interest to the Government, from the dates of payment on the items held to be improperly expensed and on a portion of the reformation claim (R 467). Hanna on its cross-appeal challenges this, contending that the award of prejudgment interest is improper in this case.

As to the amounts at issue: The judgment below awarded the Government $473,304 ($231,506 on 38 items and $241,798 on reformation) plus certain prejudgment interest.[7] The Government contends that if it prevails on all issues in this Court, it should be awarded an additional $1,168,671 plus interest. If Hanna prevails on all issues in this Court, the award to the Government would be reduced to $231,506 with interest only from the date of judgment.

The issues which this Court is called upon to decide are whether, as the Government asserts on its appeal, the District court erred in holding that

(a) generally accepted accounting practice governs as to capitalizing or expensing the items in issue;

(b) the evidence showed that under such practice the items in issue were properly expensed;

(c) estoppel barred the Government's claim as to items expensed after 1957 (which question need not be decided if it is concluded that (a) and (b) were

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7. The amounts awarded by the District Court are itemized in Appendix B, p 96 below.

and whether, as Hanna asserts on its cross-appeal, the District Court erred in

(d) reforming the 1961 amendment to reflect an agreed formula rather than an agreed figure;

(d) allowing prejudgment interest.

SUMMARY OF ARGUMENT

1. The District Court's interpretation of the terms of the contract, ambiguous in their definition of the accounting standards to be applied under it, was based on extensive oral and written evidence. It was clearly correct and cannot be disturbed on appeal. The eminent accounting witnesses testifying in support of Hanna's position agreed that the contract did not provide a self-contained accounting system which required replacements and improvements to be capitalized, that accounting standards outside the terms of the contract had to be used in determining whether specific expenditures should be paid for with capital advances or working capital advances, and that the contract could only be administered according to generally accepted accounting practice. The Government's own expert witness had to rely on outside accounting standards

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8. The Government's third specification of error (Gov Br 29) -- the failure of the District Court to hold The Hanna Mining Company liable on a guarantee contract (DMP-51) -- does not require the Court's consideration; defendants have at all times recognized that Hanna Mining is guarantor of any liability of Hanna Nickel Smelting Company.

to support the Government's claim. The Government's view as to the "unambiguous" cost accounting system prescribed by the contract has undergone repeated changes, and as now stated the "syst has no relation to the contract terms and has become wholly unintelligible.

The District Court's interpretation of the contract is wholly consistent with the evidence of the contract negotiations and the practical construction given to the contract by the partie over a period of nearly eight years. Contrary to the Government's contention, the District Court's interpretation does not deprive the Government of any rights under the contract or conflict with any of its terms.

2. The District Court correctly found that the accounti practices applicable to the contract were those common to the smel industry. Accounting practice is only the application in specifi cases and under specific circumstances of the principles which un lie accounting theory. This was a smelting contract, and the gen accepted accounting practice applicable to it was necessarily pra applicable to that industry. The evidence was conclusive that un practices applicable to the smelting industry, the disputed items were properly charged to cost of production. The Government's co tradictory evidence on applicable accounting practices was abstra inconsistent and in large part unintelligible.

3. It is undisputed that the Government was fully informed of the accounting practice applied by Hanna under the cont by the end of 1957 and acquiesced therein until March, 1962 when it first disputed the company's accounting treatment of items

purchased in 1959 and 1960. Following 1957, Hanna relied on the Government's acquiescence in that practice, thereby increasing substantially its exposure in this action and incurring expenses which it could have and would have avoided if the Government had objected or otherwise made its position known prior to 1962. The District Court correctly concluded that the Government was estopped to asserts its claim for items now in issue which were paid for after January 1, 1958.

ARGUMENT

I.

The District Court correctly found that the contract did not contain a complete and unambiguous cost accounting system and that generally accepted accounting practice was to be applied in its performance.

The main issue on the Government's appeal is whether certain disputed expenditures were properly expensed and charged to cost of production, as Hanna contends and as the District Court held.

The crucial analysis and findings of the District Court on the question of the interpretation of the contract (R 383-384) are as follows:

> "The Government contends that the 216 disputed items are replacements and improvements of the smelter which are eligible for capital advance treatment under Article VI, paragraph 1(c). It also contends that such expenditures must be capitalized

and financed under that provision, since the definition of working capital and actual cost of production refer only to expenditures 'not covered by Capital Advances.'

"The contract does not define the terms 'replacement' and 'improvement.' The Government originally argued that all items which, descriptively, are replacements or improvements are included within the capital advance provision. The Government now concedes that this position is untenable and that the replacement of a light bulb, for example, is not a capital expenditure. At the beginning of the second trial, it conceded that 68 of the items originally contested were properly expensed as repair and maintenance costs.

"I find that the terms in Article VI, paragraph 1, are ambiguous, and that other provisions relied on by the Government do not resolve the ambiguity * * *.

"I find that the terms 'replacement' and 'improvement' as used in this contract are terms of accounting art. In determining how to account for a particular item, an accountant must look beyond the contract and rely on generally accepted accounting principles and practices."

The Government as appellant contends (Gov Br 38-39; see also 11-17, 31) that the contract, while complex, is not ambiguous (the trial court found it was); that the contract "established its own accounting system, 'under which expenditures for additions, modification, replacements and improvements to the smelting facility should be capitalized, and not treated as costs of production" (Gov Br 38); and that the District Court (and Hanna) erred in applying generally accepted accounting practice to determine what was to be expensed and what capitalized.

The "accounting system," which the Government purports to perceive in the contract, is found, says the Government, in Articles IV and VI (Gov Br 39-42). Article IV defined the facility which Hanna was to construct, equip, redesign, rebuild and repair

with "advances" made by the Government as provided in Article VI. Article VI stated the conditions under which each of the two types of "advances" would be made: "Capital Advances" would be made on request as required "(a) to test the process * * *, (b) to construct, equip, design and rebuild the Facility * * *, (c) for such replacements or improvements of the Facility which are agreed * * * to be necessary or advisable * * *, and (d) for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized." "Working Capital Advances" would be made on request for "reasonable minimum working capital requirements" and could be used "to pay any costs and expenses hereunder * * * not covered by Capital Advances * * *." Capital advances and working capital advances were to be kept in separate bank accounts and not commingled.

The foregoing is the self-contained "accounting system" which the Government says required that all expenditures for "additions, modification, replacements and improvements to the smelting facility should be capitalized, and not treated as costs of production" (Gov Br 38).

But the contract says no such thing, and the record shows beyond any question that the contract did not contain an unambiguous accounting system as contended by the Government: (1) Four eminent accountants could perceive no cost accounting system in its terms and testified that generally accepted accounting practice had to be used under the contract; (2) the Government's accounting expert found it necessary to use accounting criteria external to the contract in order to support the Government's claim; (3) the

Government's own position as to the "clear" meaning of the contra has changed drastically and repeatedly over the years; (4) the Government's current version of the contract's self-contained accounting system bears no relation to the contract terms and is unintelligible.

The District Court's finding that the contract terms did n provide an unambiguous accounting system was clearly correct, and under Rule 52(a), Federal Rules of Civil Procedure it cannot be disturbed. Pacific Portland Cement Co. v. Food Mach. & Chem. Cor (CA 9 1949) 178 F2d 541 presented a closely similar question. That case concerned the proper interpretation of the phrase "cost of production" contained in the price escalation clause of an output contract for gypsum produced in an experimental plant. Th question was whether it contemplated price changes reflecting inc in indirect as well as direct costs of production. The District Court received evidence of the contract negotiations and expert accounting testimony. It found that the contract was ambiguous a on the record, interpreted it, as the seller contended, to includ increases in direct costs. On appeal, this Court defined the applicable standard of review of such findings:

> " * * * If, on the other hand, the language of the contract is not plain, two situations may present themselves: (1) the contract may contain technical or trade terms, as to which the testimony of those skilled in the art or experts in the field is admissible, or (2) the contract may contain ambiguities which need extrinsic facts to explain. Whichever of these situations confronts us, its solution, on appeal, brings up the same question -- is there evidence in the record from which different conclusions might have been reached? If so, it cannot be said that the conclusion reached by the trial court is clearly erroneous." (178 F2d at 549)

" * * * we have an issue framed and decided by the trial court upon contradictory testimony, both lay and expert, with ample evidence in the record to support the view adopted by the trial court. * * *" (178 F2d at 553-554)

The court sustained the District Court's contract interpretation, which resolved a conflict in expert accounting testimony (at 553-554):

" * * * we cannot say that the Court's finding is 'clearly erroneous',when the matter was one of choosing between two contending theories of accountancy." (178 F2d at 558)

Under Rule 52(a) of the Federal Rules of Civil Procedure findings of the District Court are conclusive on appeal unless clearly erroneous. The findings in the present case, quoted at pages 15-16 above, are not merely supported by substantial evidence; they state the clearly correct and only proper view of the situation under this contract -- as demonstrated below.

a. Hanna's expert accounting witnesses testified that the contract did not contain a cost accounting system and that generally accepted accounting practice had to be applied in its performance.

The witnesses in support of Hanna's position were Richard . Baker, managing partner of Ernst & Ernst, with 25 years of xperience with that firm (July Tr 155); Bruce Smith, a partner of rice, Waterhouse, with over 30 years of accounting practice (July Tr 98, 199; Def Ex 127); Maurice Peloubet, a partner in Price,

Waterhouse with 55 years of accounting practice (July Tr 216; Def Ex 128) and John Queenan, managing partner of Haskins & Sells, with 38 years of accounting experience (July Tr 229; Def Ex 129). These four eminent and experienced accountants could find no self contained cost accounting system in the contract.

Mr. Baker, whose firm, Ernst & Ernst, had performed periodic audits during performance of the contract, testified that his firm concluded that under the contract generally accepte accounting practice governed accounting decisions (July Tr 158), and that when they sought to interpret the contract for accountir purposes there was no doubt in their minds that generally accepte accounting practice should prevail (July Tr 161). The contract does not contain the detailed cost accounting criteria generally found in Government contracts, and "the only criterion that could be used from an accounting standpoint is generally accepted accou ing practice" (July Tr 193-194). Mr. Baker explained that an int pretation of the contract which would require capitalizing -- and capital advance treatment -- for literally all "replacements," such as light bulbs, made no sense and was obviously not intended (as the Government witness, Dr. Wright, conceded -- July Tr 49); hence, some interpretation of the contract was necessary to deter mine which replacements should be capitalized and which expensed, and the appropriate tool for interpretation was generally accepte accounting practice (July Tr 246-247). The other experts testifi to the same effect -- that generally accepted accounting practice had to be applied, because as accountants they could perceive no other cost criteria (July Tr: Smith 211, 279; Peloubet 221-222; Queenan 230-231).

b. The Government's expert accounting witness found t necessary to have recourse to accounting criteria outside he contract in order to support the Government's claim.

Initially in this litigation, the Government took the osition that all items which were literally "replacements" or improvements" had to be capitalized. Then it retained Dr. Wright s an expert. He reviewed the Government's list of 284 items on hich its initial claim in this suit was based, and concluded hat a number of them were in fact properly costs of production nd should not have been challenged by the Government. Accordingly, he Government at trial withdrew its claim as to 68 items ($346,222) - ten of which, incidentally, were each in excess of $10,000.[9] hy did Dr. Wright recommend this? In his words:

> " * * * I could not believe as an accountant that every single replacement of a minor working part should have been treated other than as a cost of production item. Therefore, for some of the items which GSA described as being replacements of existing assets or partial replacements of assets, I recommended the change in classification. * * *"
>
> (July Tr 49)

ncidentally, Dr. Wright himself used generally accepted account- ng practices in his attempt to construct a meaningful contract ccounting standard. He freely admitted that in preparing his lassification of the disputed items (Pl Ex 90), generally ccepted accounting practices had "significant impact" (July Tr ?).

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9 See R 334, 378; July Tr 7, 37. The items were those in Pl Ex 90, Category 10. They included Item 114, which cost $28,676.78; Item 171, which cost $30,239.85; Item 172, which cost $40,874.00; and Item 263/274, which cost $21,615.40.

In short, the Government and its expert witness recog nized the impossibility of relying exclusively upon the literal language of "replacements or improvements" in Article VI(1) of the contract -- some external accounting criteria had to be applied.

c. The Government's view as to the "unambiguous" meaning of the contract has undergone several inconsistent chan

(1) On February 6, 1953, less than a month after execution of the contract, a Government letter to Hanna referre to "generally accepted accounting principles" as the applicable accounting standard under the contract (Pl Ex 95, p 2). On February 27, 1959, in a letter on behalf of the Government to Hanna (Def Ex 108), Mr. Louis Brooks, Deputy Director of the Office of the Comptroller, applied "generally accepted account- ing practice" to all capital advances under Article VI(1). On March 14, 1962 the Government made its initial claim with respe to certain items in issue in this action, asserting (Def Ex 125 as the sole basis for its claim that Hanna had departed from "generally accepted accounting principles." Then came the lawsi

(2) The Supplemental Pretrial Order contains the Gv ernment contentions as of June, 1965: Hanna was obliged to cap ize, among other things, "all replacements and improvements of h

acility" (R 303) and had improperly expensed 284 items "of a apital nature," which it should have capitalized "without con- ideration of generally accepted accounting practices" (R 302). t this point, the Government was relying upon both clauses (b) nd (c) of Article VI(1) (R 302, 303).

(3) At the trial, this position was abandoned. Dr. right, in support of the Government's claim, drew obscure distinc- ions between replacements which improve and replacements which o not (July Tr 48-51), and thereby abandoned the contract account- ng system for which the Government contended in the Pretrial rder. The Government also abandoned its claim as to Article VI(1) b), stating to the court that all of the 216 items which it by hen still disputed were "replacements or improvements" (July Tr -5) -- i.e., they were required to be capitalized under clause (c). he District Court's opinion so states the Government's contention R 383); and the Government's statement in its points on appeal sserts that the disputed items were "replacements or improve- nts" (R 495). Thus, at the trial the Government changed its position to contend that all of the items in issue were replace- nts or improvements and simultaneously recognized that not all replacements or improvements were required to be capitalized.

(4) On appeal, the Government now says it is not only dealing with "replacements" and "improvements," but also "additions" and "modifications" (Gov Br 29). This change demon- strates the continuing flexibility of the Government's position in this case and underscores the fact that the "clear" meaning of

this contract to the Government varies from time to time.[10] Moreover, this latest change of position results in a purported "clear" meaning of the contract which is substantially more obscur than any of the succession of theories which have preceded it -- as the following section demonstrates.

d. The Government's most recent version of the contract bears no relation to its terms and is unintelligible.

It will be recalled that the Government bases its case on the proposition that the contract has a self-contained and clear set of cost accounting standards. Analysis demonstrates that neither is true. To this moment, the Government's position remains unclear as to what the contract's self-contained cost accounting system really is. In its Brief as Appellant it states first that this system requires that expenditures for "additions, modification, replacements and improvements to the smelting facility should be capitalized, and not treated as costs of production" (Gov Br 38). It says substantially the same elsewhere (Gov Br 12, 16, 30, 39).

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10. In addition, the Government's most recent change in position presents it with certain major difficulties: First, there are no categories of "additions" or "modifications" to be found in the contract. Second, this issue is not properly before the Court -- because the Government's statement of points on appeal presents only the issue of the propriety of expensing "replacements or improvements"; and because, if the Government sees clause (b) of Article VI(1) as the source of its new argument, that issue was abandoned at trial.

Apparently, however, the Government doesn't mean all such expenditures. For it elaborates (Gov Br 43) as follows:

> "* * * Under the accounting system contemplated by the contract, an expenditure for the replacement of a component -- rather than the entire unit -- of a specifically described item of equipment (or of an item not specifically described but agreed to by the Government) would not be covered by capital advances because it would not be an expenditure for the replacement of a specifically described item of equipment (or for the replacement of an item not specifically described but nevertheless agreed to by the Government as necessary or advisable). On the other hand, if the replacement of a component of an item effected an improvement in the item, it would be covered by capital advances under clause (c) because it would then be an expenditure for improvement of an item of equipment as specifically described or of an item added with the Government's agreement.* * *" (Emphasis in the original)[11]

This appears to mean that, in the Government's view, while the replacement or improvement of "a specifically described item of equipment" must be capitalized, the replacement of "a component -- rather than the entire unit -- of a specifically described item of equipment" must not, unless it "effected an improvement in the item," in which latter case it is to be capitalized. Perhaps consistent with this is Dr. Wright's testimony that not all "replacements" should be capitalized, but that each "replacement" which was not an improvement and which was used solely for the purpose of replacing a defective, worn out or damaged part should be expensed (July Tr 50).

This, says the Government, is the "accounting system

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11. To illustrate how much of a gloss this paragraph places on the contract, attention is called to the fact that the terms "component," "unit," "item," and "specifically described item" are not found in the contract.

established by the contract" (Gov Br 39). But the contract says such thing. Obviously, much has been imported -- from sources wh are obscure.

What is the source of the "item"/"component" dichotomy? How does one determine what is an "item" and what is a "component" (If a furnace is an "item," are all parts of the furnace "components"? Is a light bulb a "component" of the electrical system, so that an improved replacement bulb must be capitalized?) Why are "replacements" of "components" capitalized if they improve the "item," but expensed if they don't? (The contract in terms treats all replacements and improvements equally -- but the Government would read in a distinction between improving replacements and non improving replacements.)

Not only is this "self-contained accounting system" based on obscure sources, but even as now explained by the Government, it is wholly unclear. Purportedly, the Government's "syste is arrived at by looking at express provisions of the contract. One searches in vain for contract language which supports this strained, artificial and unintelligible construction of the contract, and the inference is inescapable that this is merely th last in a succession of contrived theories to support a preconceived result.

e. The Government's other arguments in support of its interpretation of the contract are without merit.

In addition to its contention that there was in the contract a self-contained cost accounting system, the Government says that generally accepted accounting practice should not be applied because of (a) the history of the contract negotiations (Gov Br 54-60), (b) the interpretation of the contract by the parties during performance (Gov Br 64-76), and (c) the effect of such interpretation of the contract on various Government "rights" (Gov Br 47-54, 61-64). The fact is that both the history of the negotiations and the parties' construction of the contract during its performance reinforce the conclusion that generally accepted accounting practice is applicable -- and this construction of the contract violates no "rights" of the Government whatsoever.

(1) The history of the contract negotiations supports the District Court's decision.

The Government contends (Gov Br 54-60) that the contract drafts evidence a deliberate decision that items such as those in question were to be capitalized without regard to generally accepted accounting practice. The drafts demonstrate no such thing. To the extent that they shed any light, they show an intention that generally accepted accounting practice was to be the

criterion for determining what should be capitalized and paid for under the capital advance provisions.

The only portions of the Government's discussion of the evidence of contract negotiations which appear to give any plausible support to its position depend wholly upon a distortion of the record, as the following demonstrates:

(a) The Government (Gov Br 56-57) quotes a draft which defined "cost of production" in terms of generally accepted accounting principles. It states that this was contained in Hanna draft of 11/24/52 (it was not; it was in a separate, partial draft dated 12/9/52 (see Pl Ex 140) and is not shown to have ever been exhibited to or considered by the Government). It then asserts that "The Government's negotiators objected to these provisions." -- as if the objection were to the definition of cost of productio in terms of generally accepted accounting principles (a disingenuous assertion, wholly unsupported; the language of the memorandu quoted immediately thereafter (Gov Br 57) makes it clear that the "objection" to the provision there under discussion was to the lac of any provision for Government approval of capital expenditures, a wholly different question on which Hanna accepted the Government's position).

(b) Similarly, there is no support for the assertio (Gov Br 58) that "the Government rejected the language suggested by Hanna" limiting capital advances to expenditures capitalizable under generally accepted accounting practice. A fortiori there is no support for the Government's subsequent bland specula tion as to the reason for this nonexistent rejection, in the

ollowing language (Gov Br 59):

> "The record does not affirmatively indicate why the definition in Hanna's drafts which would have provided capital advance treatment only for those 'replacement/s/, additions, or improvements * * * which, in accordance with generally accepted accounting practice, are capitalized' was rejected. * * *" (Emphasis supplied)

xactly to the contrary, the record shows that it was not rejected, ut rather that it survived in the final contract, as appears from he following:

It is undisputed that in the early drafts of Article I(1) only replacements or improvements which were capitalzable in accordance with generally accepted accounting practice ere to be financed by capital advances. As further provisions ere inserted in Article VI in successive drafts, the words "replaceents" and "improvements" became physically somewhat separated rom the words "which, in accordance with generally accepted ccounting practice, are capitalized." But there is no evidence o show, as the Government contends, that the negotiations intenionally eliminated generally accepted accounting practice as the riterion for determining which replacements or improvements equired financing by capital advances; and the use of the words such other necessary and so agreed upon expenditures which, in ccordance with generally accepted practice, are capitalized" shows ust the reverse intention -- that this same standard was to continue t be applicable to "replacements" and "improvements" and also to pply to other expenditures. The intention to preserve that standard i demonstrated by the fact that immediately upon conclusion of te negotiations one of the Government's negotiators, Mr. Johnston Rssell, reminded Hanna in writing that its accounting decisions

would be reviewed to assure compliance with "sound accounting practices and generally accepted accounting principles to the maximum extent possible" (Pl Ex 95, p 2).

A fuller summary of the negotiations and drafts is set forth in Appendix D hereto, pp 109-112 below.

In view of the total absence from the negotiation documents of proof supporting the Government's contention, thereby forcing the Government to rely only on inference (and unreasonable inference at that), it is appropriate to note that Col. Melville Robinson, the chief Government negotiator, was present in the courtroom during the trial and had been listed as a witness for the Government. However, he was not called to testify (July Tr 152, 292). It is reasonable to assume that if he could have testified that there was an intentional elimination of generally accepted accounting practice as the standard for determining which replacements or improvements would be the subject of capital advances, he would have been called by the Government to do so.

(2) <u>The practical construction of the contract by the parties supports the District Court's decision.</u>

(a) The record shows that throughout the life of the contract the Government insisted and Hanna agreed that generally

accepted accounting practice should be applied.[12]

This commenced during the negotiations and on January 16, 1953, when Government negotiators questioned the provision for capitalizing costs and expenses during Period 1 "down time," because, in their view, such costs should be expensed under normal accounting principles (Def Ex 83; Def Ex 122, p 3). It ended with the Government's initial demand for reimbursement on March 14, 1962, which was based solely on its

> " * * * view that, in accordance with generally accepted accounting principles, the cost of these items should have been capitalized and not expensed during the period in question, * * *" (Def Ex 125, p 1; see also P1 Ex 23, p 2)

Between 1953 and 1962, the Government's position was repeatedly and emphatically stated. On February 8, 1953 the Director for Financial Analysis of DMPA advised Hanna that:

> "In respect to the accounting methods which you will employ in connection with this contract, it is our policy to adhere to sound accounting practices and generally accepted accounting principles to the maximum extent possible." (P1 Ex 95, p 2)

In its instructions to its auditors, DMPA stated as the purpose of the examination

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2. The Government suggests that the various occasions on which Government officials contended that generally accepted accounting practices were controlling under the contract are "by no means inconsistent with the Government's position," because there is no difference between the contract standard and generally accepted accounting practice (Gov Br 76-77, fn 47). They are, of course, utterly inconsistent with the Government's contention that under "plain rules of English grammar" (Gov Br 59; see also 49), the contract language requires replacements and improvements to be capitalized without regard to generally accepted accounting practices.

> " * * * that the final figures shown therein be given adequate audit treatment to see whether such costs meet the requirements of generally accepted accounting principles (cost principles) and the peculiarities provided in Amendment No. 3, page 3, substituting paragraph 1 of Article VI of the original contract." (Def Ex 48, p 4; emphasis supplied)

On February 27, 1959 Mr. Louis Brooks, Deputy Director of the Office of the Comptroller, objected to the company's calculation of the 1959 amortization rate on the ground that

> " * * * it is our understanding of 'generally accepted accounting practice', as that term is used in Article VI-1, that costs are not capitalized until they have been incurred." (Def Ex 108)[13]

Finally, the Audit Division report by R. B. Brown dated February 7, 1962 questioned the expensing of certain disputed items because it was of the view that they should have been capitalized "in accordance with generally accepted accounting practice" (Def Ex 77, pp 2-3; see also Exh B thereto).

During the performance of the contract, Hanna and its accountants shared the Government's view of its proper constructic The Ernst & Ernst reports which were reviewed each year in the cou of the Government's annual audits utilized generally accepted accc ing practices (July Tr 158), including the company's practice dis- puted in this lawsuit of expensing replacements and improvements of items which did not work as originally planned. The company's practice was described in the notes of Mr. Richard Joliat, of Ernst & Ernst, which were reviewed by Government auditors during their annual audits (Oct Tr 235-260, 265-266). The trial judge

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13. Note that he discusses "generally accepted accounting practice" in terms applicable to all capital advances under Article VI, not merely advances under (d).

found (R 390), and it is not denied on appeal, that by the end of 1957 the Government knew all about the company's accounting practice. The evidence shows, in addition, that whenever it was to its advantage, the Government insisted that the use of generally accepted accounting practice was required by the contract.

(b) The Government (Gov Br 64-76) enumerates various instances which, it says, demonstrate that Hanna interpreted the contract as requiring capitalization of expenditures "virtually identical" to the ones now in issue (Gov Br 75) and thus acted inconsistently with "the theories advanced by Hanna in this litigation and held applicable by the district court" (Gov Br 65). The Government's references establish no such thing.

Several of the instance referred to by the Government (Gov Br 64-69) relate to expenditures for the construction of the facility. Mr. Spang's correspondence of April 7, 1953 (Pl Ex 42), February 28, 1955 (Pl Ex 44), March 8, 1955 (Pl Ex 45) and January 4, 1956 (Pl Ex 47) by their terms request approval of earlier expenditures for original plant construction. All of those expenses were capitalized in accordance with generally accepted accounting practice (Baker, July Tr 244-245). Similar considerations apply to the Government's reliance (Gov Br 68) upon Hanna's proposal in June, 1955 that working capital be authorized for capital expenditures to cover the estimated cost of items not included in the Bechtel estimates (Def Ex 105, pp 5-6). The Government has not shown that any of those items should have been expensed -- instead of capitalized -- under the accounting practices followed by the company and none of them is in issue in this action.

The Government also relies (Gov Br 70-76) on internal company correspondence relating to Hanna's request in 1957 for additional capital advances, which eventually led to Amendment 4 increasing the capital advance ceiling by $875,000. For example, in February, 1957 Hanna's plant manager included improved dutch ovens in his itemization of capital needs (Pl Exs 51, 52). This characterization of his requirements was not, of course, an accou decision -- which could be made only by the company's accountants Nor was it carried forward into any action of the company. None of the additional money was spent for such items.

It is significant that in none of the cited correspond- ence and memoranda is there any suggestion that the standard for determining what was to be capitalized and what charged to cost of production was anything other than generally accepted accounti practice -- the standard which, as above indicated, had been reit erated by both parties from the execution of the contract to the filing of the claim on which this litigation is based. The most that can be claimed for any of the materials relied on by the Government from pages 64 to 76 of its brief is that some of them indicated uncertainty or differences of opinion or inconsistency within the Hanna organization as to the application of the standa of generally accepted accounting practice.

Nor is this strange. The Government's accounting witne himself testified (July Tr 39-40) that accounting is not an exac science and that differences of opinion among equally qualified accountants would undoubtedly be encountered on the questions of judgment at issue here. The proposition that generally accepted

accounting practice was and must be the standard of reference is not in the least undermined, therefore, by a showing that consideration was given, for example, to requesting capital advances to extend the slag disposal facilities or to replace the dutch ovens, when, upon a final accounting determination, these items were expensed. And for the same reasons such preliminary differences of opinion are not in the least inconsistent with the trial court's finding, based upon the heavy prepondernace of accounting testimony, that such accounting was proper.

(3) The District Court's decision does not impair the Government's rights under the contract.

The Government contends (Gov Br 47-54) that the District Court's interpretation of the contract deletes some of its provisions and is incompatible with others and (Gov Br 61-64) that it deprives the Government of its "veto" over capital expenditures. Neither contention is valid.

(a) The Government's contention that under the District Court's interpretation of the contract replacements would "never" be capitalized but would "always" be expensed and that improved equipment will "rarely" increase the value or capability of the smelter as a whole (Gov Br 50-51) is not only speculative, but is also incorrect. As an example, most of the new dust collection system, which was a replacement and improvement of the original

equipment, was admittedly capitalized to the extent of almost $700,000 (Pl Ex 82, Item 49).

(b) The expenditure regarded by the Government as a "striking example" of the District Court's asserted error, namely expensing of the two dutch ovens acquired in 1957 (Gov Br 51, 15-16) is in fact an excellent illustration of the reasons why two factors so much emphasized by the Government -- the size of the particular expenditure and the estimated useful life of a piec of equipment considered in isolation -- are not controlling.[14] For, as pointed out by Bruce Smith (July Tr 208-209), these items substantially duplicated the previously existing ovens and were substantially similar units; the capital account should not contain two sets of dutch ovens when only one remained; the cost of either the old or the new (which were nearly the same) should be expensed; and in all the circumstances, what was done was proper.

(c) The contention that the Government was deprived its contract "veto" over capital advance items is based wholly on circular reasoning: Whether the disputed expenditures were subje to the Government's prior agreement depends upon their proper accounting treatment, i.e., whether they were to be paid for with capital advances or working capital advances. That is precisely the issue in this case. To contend that the Government was wrong fully deprived of its contract right to be consulted merely assum the answer to the question in dispute. The Government did not ha

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14. Consider Pl Ex 82, Item 114, costing $28,676, the useful li of which the Government estimated at 15 years (Pl Ex 166) a which the Government conceded was properly charged to expen

he right to be consulted about expenditures which were properly llocated to the cost of production, and the trial court correctly ound that the expenditures in question were properly so allocated.

The District Court's interpretation neither emasculates he contract nor deprives the Government of any rights.

II.

Under generally accepted accounting practice applicable to the contract, the disputed items were properly charged to cost of production.

a. The determination of applicable accounting practice s controlled by the fact that this was a smelting operation.

The District Court found that under generally accepted ccounting practice the 178 items challenged by the Government on his appeal were properly expensed and charged to cost of produc- ion. The Government contends, alternatively (Gov Br 77-81; see lso 17-18), that even if generally accepted accounting prac- tice is applicable under the contract, the District Court erred n applying accounting practice in the smelting industry and that he court should have applied generally accepted accounting practice n the abstract or else practice applicable in some other industry.

It is difficult to believe that this contention is s riously made. It flies in the face of common sense, and is olly inconsistent with all of the expert testimony. Dr. Wright t stified that

"Generally accepted accounting practices are the mechanisms by which a particular company achieves the objectives of generally accepted accounting principles in the measuring process." (July Tr 78)

Mr. Baker testified that generally accepted accounting practice

" * * * is the application of these broad general principles to a given situation * * *" (July Tr 159)

The trial court correctly stated (R 384):

"These experts all agreed that accountants rely on a relatively small number of accounting principles and that many accounting practices have been developed to apply basic principles to various accounting situations.

* * * * *

"In my opinion, the parties intended to apply accounting practices common to the smelting industry. I find that the company properly treated the smelter a a single capital unit." (R 387)

Despite the fact that this was a smelting operation, the Government would have the Court impose practices applicable to a manufacturing operation (Gov Br 50, 81, note 48) -- or else generally accepted accounting practice as a completely abstract concept (Gov Br 18, 24-25, 32, 34, 55 note 38, 60, 77 note 47, 79).

However, the record shows that the application of genea accepted accounting practice varies from industry to industry, and there are both differences and similarities between generall accepted accounting practices applicable to manufacturing compane and smelting companies (July Tr: Smith 201-204; Baker 159-160, 164). The evidence is uncontroverted that applicable accounting practice is determined from the contract terms and the nature of the industry and the operation conducted under it and all othr

ircumstances (July Tr: Baker 159).

It follows that accounting practice exists only in a specific factual context. "Generally accepted accounting practice" applicable to this contract consists of the accounting practices applicable to the specific operation conducted under it -- i.e., to the facts which the contract contemplates and which arose under it. The accounting practice contemplated by the parties is that which is accepted by accountants as applicable to those facts. The only "generally accepted accounting practice" relevant to this contract was that of the smelting industry.

b. The evidence showed that under applicable accounting practice, the District Court's decision was correct.

Hanna's expert accounting witnesses testified in clear and convincing terms about the accounting practices which are applicable to smelting operations, and their testimony fully supported the decision of the District Court. In determining whether to capitalize or expense an expenditure, the accepted practice in the smelting industry is to consider its effect on the entire smelter as a single unit and not its effect on any part considered separately from the whole. This fundamental concept was concisely stated by defendants' expert, Bruce Smith, in the following language:

> " * * * /W/hat might be a unit of equipment in a manufacturing operation is only a part in the smelting operation. That the smelter is in effect one facility and that that is the justification when we get to makin substitutions of what might appear from a textbook standpoint to be whole pieces of equipment, that so far as a smelter operation is concerned, they are merely parts in the one overall process." (July Tr 202-203)

This accounting practice is dictated by the nature of a smelting operation. Unlike many manufacturing operations, a smelter is designed for the production of a single product on an around-the-clock basis, and the units of equipment which make up the component parts of such a facility are functionally interdependent in much the same way as the component parts of an automobile engine are interdependent and designed for the performance of a single function (July Tr 164-165, 202-204). Because he was apparently unaware of these important characteristics of a smelte operation, Dr. Wright, in considering the effect of a given exper diture, focused his attention upon individual components of the facility rather than upon the facility as a whole. As a result, he reached different, and in this case, erroneous conclusions.

Hanna's expert witnesses testified that these accountir practices had been applied by them in reaching their conclusion that the disputed items were properly charged to cost of product (July Tr: Baker 163; Smith 200, 211; Peloubet 222; Queenan 230-3 The Government's contention that the evidence required a contrar opinion is wholly without substance.

c. The District Court correctly denied the Government's claim with respect to expenditures for removing and replacing equipment in the dust collection system.

Apart from its other propositions in this case, the Government contends (Gov Br 81-85; see also 22-23) that $114,234.82 of its claim for $198,746.62 for expenditures incurred in connection with installing the new dust collection system (Pl Ex 82, Item 49) should be allowed by this Court on the basis of a stipulation after trial that that amount was spent for "fabrication, equipment, erection and installation of new dust collection equipment" (R 336-337). The Government states erroneously that its claim was resisted in the District Court on the "sole" ground that the disputed amount "was spent solely to remove the old equipment," and that the stipulation disproves that defense (Gov Br 84).

The Government grossly misrepresents Hanna's defense and the District Court's decision. It is agreed that expenditures for new equipment were capitalized, and that the disputed expenditure "represents expenditures for removing old collectors and removing and replacing the auxiliary duct work" (Pl Ex 82, Item 49) (see also July Tr 182, 256-257). The existing duct work was worn out and poorly located; consequently, classifying this expenditure for replacement as well as removal of the duct work as a cost of production was proper under the company's accounting practice which was known to the Government and was sustained by the District Court (July Tr 257). Hanna did not claim and the District Court did not find that the amount charged to cost of production represented expenditures "solely" to remove the old equipment. Hanna did

claim that the money was spent, as the District Court found, "to remove and replace the original, inadequate equipment" (R 381), which was the stipulated fact (Pl Ex 82, Item 49).[15]

The only question before this Court is whether the expenditure was properly expensed, and the evidence fully supports the District Court's decision that it was. This expenditure was distinct for accounting purposes from the various parts of the new dust system which were capitalized (July Tr 182-183, 256-257), and the Government's claim, which is based upon a misstatement of Hanna's position and the decision of the District Court, is without merit.

III.

The District Court correctly concluded that the Government was estopped to assert a substantial part of its claim.

The District Court found:

> "As an alternative ground of decision, I find that, with two exceptions, the Government is estopped by acquiescence from asserting any claim for expenditures made after January 1, 1958. * * *
>
> * * * * *
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> "I find that the Government knew of the accounting practices principally in dispute in 1957 but failed to protest at that time or at any time during the contract period. Its silence led the Company to continue using the practices and to increase its exposure in this action by almost $750,000.

15. The suggestion that the District Court acted inadvertently in failing to sustain the Government's claim is erroneous. The Government's present contention was fully developed during the trial upon the cross-examination of Mr. Baker (R 257-258). That evidence and the stipulation were both before the District Judge when he decided the case.

* * * * *

" * * * The Company asserts that it understood the Government's silence to indicate approval of the Company's accounting practices. Had the Government objected, the Company might have been able to resolve the dispute without increasing its exposure. I find that the Company relied to its detriment on the Government's silence.

* * * * *

"The evidence in this case shows that the Company consistently followed most of the accounting practices now in dispute and that Government agents, charged with the duty of investigating and reporting on the Company's accounting practices, were aware of the accounting decisions now in dispute by the end of 1957.

* * * * *

"I find that the Government, through its agent Pattarson, knew as much about the Company's accounting practices, with the exceptions already noted, by the end of 1957 as it knew in 1963. Particularly because the contract definition of capital expenditures was so ambiguous, the Government, in good conscience, should have informed the Company of its objections in 1957. I find that the Government was under a duty to speak in 1957."

(R 390, 391, 394-395)[16]

The Government concedes the correctness of the finding that its representatives knew about Hanna's accounting practices by the end of 1957 (Gov Br 87).[17] It does not assert, as it did below, that it could not be bound by the knowledge of these

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16. The Court excluded from the scope of the estoppel six major items and certain minor items costing less than $1,000 each. It found that expensing these items was not consistent with the accounting practices made known to the Government in 1956 and 1957 (R 390).

17. In its opinion, the District Court reviewed in detail the evidence which proved that the Government, through its responsible agents, knew of Hanna's accounting practice but failed to object to it, thereby permitting the company to increase its exposure in this action (R 390-394).

representatives. On appeal, the Government contends that its conduct amounted to laches, not estoppel, and that the sovereign is not barred by silence to assert "public rights" (Gov Br 89). It also contends that various of the elements of estoppel are not present.

a. In this case, the Government's rights and obligation are the same as those of a private suitor.

Unlike the cases cited by the Government, this is not a situation involving an exercise of the sovereign power of the United States;[18] it was a procurement contract between the Government and Hanna for the production and sale of nickel. As to this contract, the Government stands in the position of a private litigant and is subject to the same express and implied rights and obligations. In Krupp v. Federal Housing Administration, (CA 1 1961) 285 F2d 833 at 836 the court said:

> " * * * When the government goes into the market place it must go as everyone else. The public treasury may be protected by conditions imposed by Congress, or

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18. Utah Power & L. Co. v. United States, (1917) 243 US 389 concerned the right to occupy public forest land contrary to law, not the performance of a contract with a private party for the purchase and sale of personal property. Costello v. United States, (1961) 365 US 265 was a denaturalization proceeding. Finally, Federal Crop Ins. Corp. v. Merrill, (1947) 332 US 380 involved the liability of a federal corporation on an insurance policy issued without authority and in violation of applicable law. The Government does not assert on this appeal that Hanna's claim is based on unauthorized conduct of the Government's agents or that the transaction was in any respect illegal.

by lawful regulations, Federal Crop Ins. Corp. v. Merrill, * * *, but if the matter is left to contractual provisions and to the courts, all parties there must stand alike. We cannot recognize one rule for the government, and another for private litigants. * * *"

In United States v. Bostwick, (1877) 94 US (4 Otto) 53 at 66, the court said:

"The United States, when they contract with their citizens, are controlled by the same laws that govern the citizen in that behalf. All obligations which would be implied against citizens under the same circumstances will be implied against them. * * *"[19]

This principle is not disputed; as the District Court properly concluded,

" * * * The Government admits that it can be estopped when one of its agents, acting within the scope of his authority, makes a representation on which another relies to his detriment."
(R 390)

b. The failure of the Government to object to Hanna's accounting decision estopped it to assert its claim in this action.

The silence of Government agents in failing to make

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19. See also Clearfield Trust Co. v. United States, (1943) 318 US 363 at 369; Perry v. United States, (1935) 294 US 330 at 352; Lynch v. United States, (1934) 292 US 571 at 579; Giustina v. United States, (DC Or 1960) 190 F Supp 303 at 308, aff'd (CA 9 1963) 313 F2d 710. Estoppel is within the obligations thereby assumed by the Government: Dayton Airplane Co. v. United States, (CCA 6 1927) 21 F2d 673 at 674; Branch Banking & Trust Co. v. United States, (Ct Cl 1951) 98 F Supp 757 at 766, cert den (1951) 342 US 893. Additional authorities are collected in United States v. Certain Parcels of Land, (DC SD Cal 1955) 131 F Supp 65 at 71-76.

any objection to the performance of supply or procurement contracts has repeatedly been held to estop the Government to assert claims for breach of contract or to establish binding waviers of their terms, particularly where, as here, the Government's rights are proprietary, not sovereign. In Roberts v. United States, Great American Insurance Co., (Ct Cl 1966) 357 F2d 938 at 946-947 the court said:

> " * * * By the Government's acquiescence and silence, plaintiff was led to believe that no claim would be asserted for the savings. Under these circumstances we hold that the failure of the contracting officer to make an equitable adjustment, within a reasonable time after it was apparent that savings had been realized and in time for the contractor to appeal any dispute on the matter to the head of the department, constituted a waiver by the Government of any entitlement to the claimed savings. As this court stated in Branch Banking and Trust Company v. United States, 98 F. Supp. 757 * * * (1951), cert. denied 342 U.S. 893 * * *, when the Government is acting in its proprietary capacity, it may be estopped by an act of waiver in the same manner as a private contractor. Such a result is justified by the plain language of the contract and accords with the principles of fair dealing."

In Maizel Laboratories, Inc., 1963 BCA ¶ 3898, the Board held:

> " * * * when the Government with full knowledge of a contractor's quality control procedure permits the contractor to perform the contract in accordance with such procedure, either as constituting compliance with the quality control requirements of the contract or an authorized deviation from such requirements, this results in a waiver of any objections the Government might otherwise have raised to the contractor's quality control procedure with respect to the contractor's performance up to the time the Government put the contractor on notice that its procedure is unsatisfactory to the Government where, as here, retroactive compliance is impossible."
>
> (at 19,351; emphasis added)

In McQuagge v. United States, (DC WD La 1961) 197 F Supp 460 the Government was held to be estopped by its silent acquiescence to assert a counterclaim for breach of contract when its authorized representatives knew the facts and the contractor relied to his detriment on its failure to object. The court said:

> "The government's argument that waiver and estoppel cannot be invoked against the sovereign must be qualified in light of the foregoing authorities. * * *
>
> "Here, as shown, acting through its authorized officers and agents, the government acquiesced in the performance of the contract by McQuagge without questioning the alleged failure of the concrete to measure up to specifications according to, significantly, the government's own tests, the authenticity of which is open to serious doubt."
>
> (197 F Supp at 471)

In United States v. Certain Parcels of Land, supra, (DC SD Cal 1955) 131 F Supp 65 the District Court held that the Government was estopped by implied acquiescence from asserting a claim to title to certain improvements on property located at Los Angeles Harbor which was being condemned. After reviewing the equitable principles on which estoppel rests, the court said:

> "The Government's implied acquiescence through delay is shown by its failure to take any action to protect the property right which it now asserts in the improvements, though its agents concerned in the matter knew of Outer Harbor's actions in refurbishing the warehouses and in finding a tenant for them. * * *"
>
> (131 F Supp at 75)

See also David J. Joseph Co. v. United States, (Ct Cl 1949) 82 F Supp 345 at 351-352.

c. All of the elements of estoppel were shown in the record.

The Government does not deny (Gov Br 87) that its responsible agents knew all about the accounting practices employed by Hanna. This knowledge must, in any case, be assumed in light of the authority and obligation of the auditors to report their findings to higher authorities. Carrier Corporation v. United States, (Ct Cl 1964) 328 F2d 328 at 336-337.[20] Nor does it deny that it is bound by the knowledge of its agents acquired in the performance of their duties[21] or that they were authorized and obligated to communicate their findings to their superiors. It places principal reliance on the assertion that Hanna did not rely to its detriment upon the implicit representation of the Government that the accounting practices employed by it were consistent with the contract.

That the other "elements" of estoppel briefly charged to be missing (Gov Br 92) are present in the record is established

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20. See also Bowen v. Mount Vernon Sav. Bank, (CA DC 1939) 105 F2d 796.

21. In this regard, see United States v. Shelby Iron Co., (CCA 5 1925) 4 F2d 829 at 833, rev'd on other grounds (1927) 273 US 571:

> " * * * The government is as much bound by notice t of its agents as is an individual or private concern. * * *"

The Supreme Court approved the decision of the lower courts if, upon a retrial, there should be proof of actual notice of the company's claim (273 US at 581-582). See, generally, Restatement of Agency 2d, § 272; Prudential Ins. Co. v. Saxe, (CA DC 1943) 134 F2d 16 at 30-31, cert den (1943) 319 US 745.

from an examination of the "definition" relied on by the Government. 3 Pomeroy's Equity Jurisprudence (5th Ed) 189, 191-192. Professor Pomeroy's discussion of the elements of estoppel absolutely disproves the Government's contention which purports to be based upon it. Thus, it has been shown, pp 45-47 above, that "silence -- amounting to a representation * * * of material facts" is sufficient and that an objection to the sufficiency of contract performance is a material fact which can be lost by failure to assert it. Secondly, it is sufficient that the circumstances of this case made reliance "natural or probable" -- there need not be any "expectation" of reliance.[22] Knowledge which is "imputed," as well as actual knowledge, is sufficient, and the trial court's finding that Government agents knew all about Hanna's accounting practices is so thoroughly supported in the record that the Government elsewhere in its brief expressly disclaims any attack upon it (Gov Br 87).

The objection that Hanna did not "change its position" in reliance upon the Government's silence (Gov Br 92) is also without merit. Hanna's detrimental reliance on the Government's silence was clearly established in the record and was sufficient to estop the Government.

In Mahoning Inv. Co. v. United States, supra, (Ct Cl 1933) 3 F Supp 622, cert den (1934) 291 US 675 the court pointed out that when an estoppel is based upon acquiescence, the party asserting the estoppel usually has not acted affirmatively to change his

22. Mahoning Inv. Co. v. United States, (Ct Cl 1933) 3 F Supp 622 at 630, cert den (1934) 291 US 675; First Federal Trust Co. v. First Nat. Bank, (CCA 9 1924) 297 Fed 353 at 356.

course of conduct, but rather, as in Hanna's case, has been misled into continuing in a course of conduct already begun (3 F Supp at 630). It is sufficient if the party has been induced to refrain from using such means or taking such action as lay in his power by which he might have retrieved his position and saved himself from loss. See, e.g., DeBobula v. Manhattan Storage & Transfer Co., (CA DC 1952) 194 F2d 885 at 886; Leather Manuf'rs Nat. Bank v. Morgan, (1886) 117 US 96.

Such reliance was shown without contradiction in the record.

(1) Mr. Spang testified that in 1956 and 1957 Hanna a the Government carried on constant discussions regarding Hanna's op ting experience and need for additional capital funds and an increase in the ceiling on production costs, so that Hanna could make a favorable determination of feasibility (Oct Tr 27-28). Amendment 4 to the contract, made as of September 30, 1957, increased the capital advances and the ceiling price, and on the strength of this Hanna determined feasibility (Oct Tr 29). Mr. Spang, who was personally involved in the amendment negotiations (Oct Tr 27), was aware of the fact that in the closing conferences with Hanna personnel Pattarson had raised no material matters (Oct Tr 31). The agreement in Amendment 4 increasing the capital advances by $875,000 and the ceiling price to 75¢ was based on Hanna's past accounting practices, projected into the future (Oct Tr 32).

Mr. Spang further testified that if in the period from June to September, 1956 the Government had raised the question

which it eventually raised in 1961, Hanna would have had various options: The obvious first course would have been to sit down with Pattarson and his superiors and try to resolve the accounting dispute which the Government has now raised (Oct Tr 31), and to resolve it in accordance with the view of Ernst & Ernst, then and now, as to what constituted sound accounting practice; if the Government had persisted in its view that the company's accounting treatment was incorrect, Hanna would have insisted on more capital money (Oct Tr 31-32); otherwise Hanna would have had to make a determination of nonfeasibility (Oct Tr 32) with the result that there would have been no loss to Hanna (Oct Tr 32-33; and see Pl Ex 1 (Art XIV (1)). The adverse consequences to the Government of a negative determination of feasibility were tremendous, for the result would have been -- in addition to a wasted expenditure of more than $22,000,000 -- the assumption of substantial liabilities (Oct Tr 32-33; and see Article XIV(1)), without developing additional supplies of scarce nickel.

In 1958, neither Mr. Pattarson nor the GAO auditors raised any questions as to the propriety of Hanna's accounting (Oct Tr 35-36, 257-259). If questions had then been raised, the same options would have been available to Hanna as in 1957, except that it could not have made a negative determination of feasibility, but would have refrained from making expenditures, except perhaps within the $875,000 of capital advances available after September, 1957 (Oct Tr 36-38).

(2) Secondly, there was over $600,000 of authorized capital advances under the 1957 amendment which was never used

and which became unavailable to Hanna in 1960, when total deliverie exceeded 95,000,000 pounds. If the Government's objection to Hanna's accounting practices had been asserted when the Government became aware of them in 1957, the money could have been used and amortized over the balance of the 95,000,000 pounds of nickel which was delivered by October 1, 1960.[23]

It is, consequently, immaterial that Hanna adopted its accounting practices before the Government's silence became relevant (Gov Br 92-93). The entire basis of the estoppel applied against the Government was that Hanna had not only done so, but told the Government that it had done so. The estoppel was only applied from the time that this knowledge was received and the Government came under a duty to speak.

The appeal from the decision of the District Court that the Government was estopped to assert a substantial part of its claim is without merit.

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23. The Government contended in the court below (R 227, 228, 303-304) that this money was not available for these expenditu without Government approval. However, the record shows that (1) the Government never disputed Hanna's judgment that specif items were necessary or advisable (Oct Tr 37; July Tr 138-139, 142-143) -- indeed, under the contract it could not unreasonably withhold its agreement; (2) part of the increased capital was spent -- with its agreement -- for items not previously requested (Pl Ex 133, 135); (3) Hanna refused to release the balance of the excess funds because the amendment had been neg tiated "to provide for contingencies not seen now" (Def Ex 126); and (4) these expenditures either reduced costs or were absolutely necessary to the operation of the smelter (Oct Tr 46-47, 58). Consequently, there is no question that the money would have been available for disputed items in 1958 and 1959.

CONCLUSION

The Government's appeal is without merit. The District Court's interpretation of the contract was correct. The contract had no self-contained accounting system, and generally accepted accounting practice had to be applied under it; the Government's alternative interpretation, which was developed and changed during the litigation, is inconsistent with the construction applied by the parties during performance of the contract and remains wholly unclear.

The evidence clearly establishes that under generally accepted accounting practice, taking into account the nature of the smelting operation conducted under the contract, Hanna's accounting treatment of the items at issue was correct.

Separately, the Government is estopped to challenge items expensed after 1957 by reason of its full knowledge of Hanna's accounting practice, its complete acquiescence therein, and Hanna's reliance thereon.

The judgment of the District Court, insofar as it has been appealed from by the Government, should be affirmed.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of the foregoing brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

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Attorney

SUBJECT INDEX

TABLE OF CASES

OTHER AUTHORITIES

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 21,232

HANNA NICKEL SMELTING COMPANY, a corporation, and THE HANNA MINING COMPANY, a corporation,

Cross-Appellants,

vs.

UNITED STATES OF AMERICA,

Cross-Appellee.

On Appeal from the United States District Court for the District of Oregon

HONORABLE GUS J. SOLOMON, Judge

BRIEF ON CROSS APPEAL

STATEMENT OF JURISDICTION

Cross-appellants[1] adopt the Government's statement of the jurisdiction of the District Court and of this Court (Gov Br 1-2).

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1. Cross-appellants will be referred to hereafter as "Hanna" and cross-appellee as "the Government."

STATEMENT OF THE CASE

Hanna adopts the statement of the case in its answering brief (p 1 above) as supplemented below.

The District Court reallocated 38 items from production costs to capital expenditures and gave the Government judgment for their cost, in the amount of $231,506 (R 465-466, 468).[2] Hanna remains convinced that its accounting decisions with respect to these items were correct and that none of the items should have been reallocated. However, this Court has only limited power to review decisions of fact made below, and Hanna has concluded upon a thorough review of the record that, although the weight of the evidence might be considered to be otherwise, there is sufficient evidence to sustain the District Court's decision on this fact question.

On the cross appeal, therefore, Hanna makes only two contentions: that the District Court erred in (a) reforming the agreed ceiling price applicable to nickel delivered under Amendmer

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2. Since production costs were included in the price paid by the Government (Art VIII), the court concluded that the Government had made overpayments for nickel in the amount of those items. Thirty-two items totaling $16,396.38 were "minor items" of less than $1,000 each. The remaining six, which totaled $215,110, were more costly items acquired late in the contract (R 388, 465-466).

5 and to Hanna's payment under the termination agreement of March 5, 1964; and (b) awarding the Government prejudgment interest on amounts found to have been overpaid for nickel. These rulings account for $329,126.89 of the final judgment of $560,632.89 (R 468-469; see Appendix B, p 96 below).

a. Reformation of the agreed ceiling price in Amendment 5 to DMP-50.

The District Court found that the agreed ceiling price of 58.77¢ per pound for nickel delivered after March 31, 1961, as contained in Amendment 5, "was computed by an agreed formula which was based upon the difference between the Company's costs of production in 1959 and 1960" (R 395). The court therefore reformed the ceiling price from 58.77¢ (the agreed figure) to 57.53¢ (a figure computed on the basis of the asserted formula in accordance with the court's determination that certain 1959 and 1960 items should be reallocated) and gave the Government judgment for $27,111.49 for nickel delivered after March 31, 1961 and $214,686.83 under the adjustment provisions of the March 5, 1964 termination agreement (R 466-467, 468-469).

Hanna contends that the District Court's finding that the agreed ceiling price of 58.77¢ under Amendment 5 was the result of an agreed formula, rather than being an agreed figure, was clearly erroneous and that the court erred as a matter of law in reforming the agreed ceiling price.

b. The award of prejudgment interest.

The District Court allowed prejudgment interest on the award for the 38 reallocated items, calculated "from the dates of overpayment," in the amount of $79,603.87, and it allowed prejudgment interest in the amount of $7,724.70, also calculated from the dates of overpayment, on the award of $27,111.49 for nickel delivered after March 31, 1961 under Amendment 5 to DMP-5 which latter award resulted from its conclusion that the ceiling price in Amendment 5 should be reformed (R 467, 468-469).

The District Court's allowance of prejudgment interest in a total amount of $87,328.57, was made without finding that Hanna acted wilfully, dishonestly or with guilty knowledge, and in the face of Hanna's contention and proof that the reallocated items, as well as all of the others, had been properly classifie as costs of production under generally accepted accounting practice.[3] The court's allowance of interest was also made in the face of its own finding that

> "There is no evidence that the Company acted wrongfully or failed to make its accounting decisions and practices known to the Government."
> (R 395)

Hanna contends that the District Court abused a limited discretion in allowing prejudgment interest from the dates of overpayment and, alternatively, that the court erred as a matter of law in awarding interest for any period prior to the Government's demands for reimbursement.

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3. July Tr: Baker, 162-163, 167-168, 169-170, 172-176, 177-17, 185-188, 259-266; Smith, 200, 206-207, 213, 276-278; Peloubet 221-223, 284-286; Queenan, 230-231.

SPECIFICATIONS OF ERROR

1. The District Court erred in finding that the agreed ceiling price of 58.77¢ per pound was computed by an agreed formula which was based upon the difference between the company's costs of production in 1959 and 1960 (R 395). Said finding is unsupported by any evidence in the record and is clearly erroneous.

2. The District Court erred in concluding that the agreed ceiling price for nickel under Amendment 5 to DMP-50 should be reformed from 58.77¢ per pound to 57.53¢ per pound (R 395-396, 466-467). Said conclusion is unsupported by any evidence and is contrary to law.

3. The District Court erred in reforming said agreed ceiling price and entering judgment applying the same, as reformed, to payments for deliveries under Amendment 5 and to the termination payment under the agreement of March 5, 1964 (R 466-467, 468-469). Sai conclusion is unsupported by any evidence and is contrary to law.

4. The District Court abused its discretion and erred in awarding the Government prejudgment interest on overpayments which it held the Government had made for nickel under DMP-50 and Amendment 5 (R 467, 468-469).

5. The District Court abused its discretion and erred in awarding the Government prejudgment interest for any period prior to the Government's demands for reimbursement (R 467, 468-469).

SUMMARY OF ARGUMENT

1. The District Court erred as a matter of law in ref ing the agreed ceiling price under Amendment 5 on the theory tha it had been computed by the parties according to an agreed "formula" based on the difference between the company's 1959 and 1960 production costs. The parties' only agreement was that the Government should pay Hanna's actual cost of production, but not more than 58.77¢ per pound. There was no evidence that they would have agreed to whatever price the "formula" might produce following an audit, or that they made any agreement not containe in Amendment 5 to which it could be conformed. The evidence showed, at most, an erroneous collateral assumption. Reforming the agreed ceiling price was not only legally wrong, but was harsh and inequitable.

2. The District Court erred in awarding prejudgment interest. The Government's claim was unliquidated and was gross excessive in amount. It was abandoned in substantial part at th commencement of the July trial. Awarding prejudgment interest will unfairly compound the substantial benefit which the reclas- ified expenditures have already conferred on the Government.

3. In the absence of wrongful or fraudulent conduct, there was no duty, prior to a demand, to repay money which had e erroneously received under the contract. If any award of prejug interest was proper in this case, it could not extend beyond th date of the Government's demands for reimbursement. The judgmet for interest, if not improper in its entirety, was excessive as a matter of law in computing interest from the dates of the over- payments which the court found had been made for nickel.

ARGUMENT

I.

The District Court erred in reforming the agreed ceiling price under the 1961 agreement.

a. The Record

Amendment 5 to DMP-50 dated April 20, 1961 (effective as of March 31, 1961) provided that 19,499,863 pounds of nickel which remained to be delivered to the Government under the contract would be delivered by June 30, 1965 and paid for at a price equal to Hanna's average actual production cost of nickel delivered during each calendar year, but not more than 58.77¢ per pound. Hanna's average actual cost of production during 1961, the only year in which deliveries were made under Amendment 5, was 61.95¢ per pound (Def Ex 123; R 33). The lower agreed ceiling price therefore became the actual price of the nickel.

The Government's theory in support of its demand that the agreed ceiling price be reformed downward was set forth in the Supplemental Pretrial Order as follows:

> "The ceiling price of 58.77 cents per pound, effective as of March 31, 1961, was computed and agreed upon by deducting, from the average cost of production per pound during 1960, the reduction in average cost of production per pound between 1959 and 1960. In applying this formula, the parties assumed that the average cost of production per pound for 1959 and 1960 reported to plaintiff by Hanna were correct; but, as set forth herein, Hanna overstated its cost of production for 1959 and 1960. Computations of the correct ceiling price per pound for deliveries after March 31, 1961, on the basis of the corrected average costs of production per pound during 1959 and 1960, results in a ceiling price of 57.70 cents per pound applicable to the aforementioned past deliveries of 2,186,409 pounds of nickel and applicable to the aforementioned undelivered balance of 17,313,454 pounds of nickel.

"The contract should be reformed to reflect the true intent of the parties which was to establish a ceiling price of 57.70 cents per pound for said 2,186,409 pounds of nickel and for said 17,313,454 pounds of nickel."

(R 305)

The background of Amendment 5

Under the terms of DMP-50, Hanna was required to operate the Riddle smelter at maximum production and to deliver all nickel produced at the smelter to the Government (Article V). The contract was to terminate on June 30, 1962 or when 125,000,000 pounds of nickel had been delivered, whichever first occurred, whereupon Hanna had the right either to convey the smelter to the Government or to retain it and pay the Government the amount of all outstanding advances plus interest and a specified residual payment. Hanna also had the right to terminate the contract at any earlier time and retain the smelter upon making the same payments to the Government (Article XIV).

By the end of March, 1961, 105,500,137 pounds of contained nickel produced at the smelter had been delivered to the Government, and 19,499,863 pounds (less than one year's production capacity) remained to be produced and delivered to the Government under the contract prior to its termination on June 30, 1962 (R 298-299; Pl Ex 136, 1-D, p 1).[4] Amortization payments for capital expenditures included in the price of nickel under Article VIII had ceased in September, 1960, when delivery of the first 95,000,000 pounds was completed. The total price

4. Pl Ex 136 is the deposition of Mr. James V. O'Dwyer and attached exhibits. Those material to this issue are numbered 1-D through 6-D.

of the balance of the nickel was its cost of production, up to a ceiling of 75¢ per pound, plus any applicable escalation (Article VIII).

Under the terms of its contract with Bonneville Power Administration, Hanna had to decide by March 31, 1961 whether it would obligate itself to buy power for the smelter for the next 12 years (with a minimum obligation in excess of $1,000,000 annually) or cut off the power arrangement when DMP-50 ended on June 30, 1962. In effect, this required Hanna to decide by March, 1961 whether it would turn the smelter over to the Government or make the residual and other payments and retain and operate it for commercial production (Def Ex 98, p 2; Pl Ex 136, 3-D, p 1). While hopes were high for an eventual commercial market for ferronickel, the high fixed costs of the smelter (principally power) required that it be operated at or near capacity in order to provide a profitable operation, and the lack of an established domestic market caused Hanna to be reluctant to commit itself to the long-term power obligation (Def Ex 98, p 2; Pl Ex 136, 1-D, p 1; 3-D, pp 1, 2).

The Government wanted Hanna to exercise its option; it had no desire to take over the smelter and no need for further nickel (Def Exs 82, p 7, 98, pp 1, 2). It did, however, have a reason for retaining its right to receive the remaining 19,499,863 pounds. The market price of nickel (at which the Government might expect to resell it) was substantially higher than the cost of production which fixed the effective price to the Government under the contract (Def Ex 98, p 2; see Pl Ex

136, p 12).[5] Thus, it was mutually advantageous for the parties to enter into Amendment 5 on April 20, 1961.

The negotiations for Amendment 5

Mr. James V. O'Dwyer, the principal Government representative in the negotiations, testified on deposition that Hanna's initial proposal of February 1, 1961 (Ex 1-D to Pl Ex 136) to terminate the contracts and extend the period for delivery of the rest of the nickel from June 30, 1962 to June 30, 1965 was unsatisfactory to GSA. However, GSA suggested further negotiations (Pl Ex 136, 2-D).

On February 27, 1961 representatives of the parties conferred. The company was willing to guarantee the Government that its cost of nickel would not be increased as a result of operations during an extended delivery period, but the Government insisted on "a valuable consideration for increasing Hanna's room for movement under the contract" and suggested a reduced price. Hanna rejected this proposal, but the Government was assured that Hanna would take over and operate the smelter if an extension of time for deliveries could be negotiated (Pl Ex 136, 3-D).

On March 2, Hanna made another proposal:

> "2. In order to provide for the continued operation of the plant while attempting to develop commercial sales to replace the Government's purchase obligations, the Government will agree to purchase during the period ending June 30, 1965, an amount of ferronickel equal to that remaining to be delivered

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5. Under Amendment 4, the cost of production ceiling price had been increased to 75¢ per pound (Pl Ex 16). Actual production costs were running substantially less than that and therefore constituted the effective price to the Government (see Pl Ex 2, 93).

under Contract DMP-50. The amount and time of deliveries would be in our discretion in order to fit into plant operations and deliveries to industry. The Government will thus be assured of receiving the remaining contract amount by June 30, 1965. The price for the ferronickel will be the lower of (i) 60 cents per pound (1960 production cost[6]) of contained nickel or (ii) our actual cost of production.

* * * * *

"We should like to point out that, in addition to being relieved of the obligation to furnish working capital for the balance of the contract as well as immediately receiving the Residual Payment of $1,750,000, the Government will be quaranteeing [sic] itself against any increases in cost of nickel for the remainder of the contract. The year 1960 was the best year thus far at the Riddle operation. We produced more pounds of ferronickel in 1960 than in any other year and at a lower cost than any other year. In August 1960, there were automatic increases in the base labor rates under terms of the contract with the CIO as well as a cost-of-living adjustment plus additional costs incurred through the adoption of pension plans for members of the bargaining unit. On August 1, 1961, there is another automatic wage increase scheduled plus a possible cost-of-living increase. Under the proposed arrangement all of these items would be absorbed by Hanna Nickel Smelting Company."

(P1 Ex 136, 4-D)

Mr. O'Dwyer opposed this proposal, because it did not give the Government the benefit of the company's declining costs:

"A Well, in the light of the descending curve and operation costs over the prior years, particularly as between 1960 and 1959, it was, I thought, that should operations under the contract continue normally and the material being produced at capacity in twelve to fifteen months, we could certainly expect to have the benefit of a lower - - - a price lower than 60 cents.

"Q What figure did you have in mind?

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6. Hanna had advised the Government in its initial proposal of February 1, 1961 that 60 cents was its "approximate" 1960 production cost (P1 Ex 136, 1-D, p 2).

"A Well, we decided the best way to approach it was to take the actual difference between the 1959-60 costs and deduct that as represented by cost per pound of nickel from the 60 cents figure, after certain adjustments were made, with respect to non-recurring costs such as the paving for the stockpile area."

(Pl Ex 136, p 15)

"We had been talking back and forth with Hanna for quite some time on the figure that had no particular basis in reason and it was my conclusion that if we could point up a reasonable approach to the thing by taking the actual difference of costs showing that as time went on the company became more and more competent in reducing costs that we could convince the company of the fairness of our position and they might find it difficult to refuse."

(Pl Ex 136, p 18)

The result of this view was the Government's proposal of March 9, 1961:

"Briefly, you propose, in effect, that deliveries under the contract be extended to June 30, 1965 and that the price to the Government be the lower of (a) 60¢ per pound of contained nickel, the 1960 production cost, or (b) the actual cost of production. In consideration of this deferral you will make the residual value payment and reimburse the Government for all working capital advances.

"We are agreeable in principle to the development of a mutually satisfactory arrangement under which the aims expressed in your communication will be accomplished. It is essential, however, that the Government satisfy itself insofar as it is possible to do so that it will not pay any more for the ferronickel to be delivered over the period of 4½ years than it would pay were the material to be delivered over the course of the next year to 15 months as provided in our Contract DMP-50.[7] To this end we call your attention to the inclusion of non-recurring charges in 1959 and 1960 and to a net reduction in production costs for the calendar year 1960 as compared with that of 1959 of 1.2¢ per pound, calculated as follows:

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7. In fact, these costs proved to be 61.95¢ operating at capacity (R 333; Def Ex 123).

	Cost Per Lb.
Average for calendar year 1959	$ .6130
Less: Storage Cost 1959 $26,292.64	.0013
Adjusted Average for 1959	$ .6117
Average for calendar year 1960	$ .6001
Less: Storage Cost 1960	.0004
Adjusted Average for 1960	$ .5997
Reduction in cost from 1959 to 1960	$ .0120
Adjusted average for calendar year 1960	$ .5997
Less Reduction in cost from 1959 to 1960	.0120
Projected Costs for Balance of Contract	$ .5877

"We think it is reasonable to project a production cost for 1961 at $.5877 per pound, and that this is a necessary precaution on the part of the Government since it has been indicated to us that during the next 12 to 15 months you may not find it practicable to operate at capacity.

"Subject to a satisfactory adjustment of all the other conditions of your proposal, with respect to which we think there will be no problem, we are willing to execute such amendatory agreements as are necessary to consummate the transaction on the basis of $.5877 per pound or your actual average cost of production during the year in which the ferronickel is delivered to the Government, whichever is lower. This contemplates that the proposed agreements will be effective as of March 31, 1961."

(Pl Ex 136, 5-D; emphasis supplied)

Mr. O'Dwyer testified that in making this proposal he intended "the basis for the computation" to be accepted as well as the price itself (Pl Ex 136, p 18). However, the letter makes no mention of Mr. O'Dwyer's asserted intent; there is no evidence that Hanna was advised of his intent, or that it was ever discussed between the parties. Nor is there any evidence that if Mr. O'Dwyer's "basis" had produced an offer by the Government of 57.53¢ per pound (the price imposed on the parties by the District Court), Hanna would have accepted it.

On March 14, 1961 Hanna replied as follows:

> "This is to advise you that Hanna Nickel Smelting Company accepts the proposal set forth in your letter of March 9 in regard to terminating Contracts DMP-49, DMP-50 and DMP-51, and substituting therefor provisions to extend to June 30, 1965 the balance of deliveries under present Contract DMP-50 at a price of $.5877 per pound of contained nickel or our average cost of production per year, whichever is lower. Your proposal contemplates that these arrangements will be effective as of the end of this month.
>
> "I assume that you will arrange to have prepared and furnished to us drafts of the appropriate agreements to carry out these understandings."
>
> (Pl Ex 136, 6-D; emphasis supplied)[8]

Amendment No. 5 provides:

> " * * * The 19,499,863 pounds of contained nickel shall be produced by the Contractor after March 31, 1961 and shall be delivered to the Government at such time or times after March 31, 1961 and prior to June 30, 1965 as the Contractor in its sole discretion shall determine, at a price per pound of contained nickel which shall be equal to (a) the Contractor's average actual cost of production per pound of contained nickel in the calendar year in which such ferro nickel is delivered to the Government or (b) $0.5877, whichever is less."
>
> (Pl Ex, p 2)

The effect of Amendment 5

Absent Amendment 5, Hanna was required to operate the smelter at the maximum practicable rate (Article V) and deliver all contained nickel produced at the smelter to the Government (Article VIII). The Amendment relieved Hanna of these obligations (Pl Ex 59, p 2). Under its terms, the time for delivery of the remaining quantities was extended from June 30,

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8. See also Def Ex 113, Hanna's response to the Government's initial demand that the ceiling price be reformed, dated June 21, 1962.

1962 to June 30, 1965 (Pl Ex 59, p 4), giving Hanna the opportunity to use most of the smelter's production during that period to develop a commercial market; the Government afforded it a market for the rest, at a price favorable to the Government.

It was clear that Hanna would not have to operate the plant at the maximum practicable rate required by the contract in order to make the remaining deliveries to the Government on the extended delivery schedule. The Government, on the other hand, wanted to be protected against paying more for the remaining nickel than the cost of production it would reasonably expect to pay if the plant were operated at the maximum rate (Pl Ex 136, 5-D). Consequently, it insisted on a sharply reduced ceiling price, which was negotiated at an amount equal to Hanna's average production cost per pound -- as then calculated -- of contained nickel delivered during each calendar year, but not to exceed 58.77¢ per pound.

Contemporaneously with the amendment, Hanna made the residual and other payments required under the contract, and it was terminated except for the Government's right to buy the remaining nickel over the extended period of three years. Deliveries under Amendment 5 were made only during 1961 (R 298-299; Pl Ex 21), and Hanna's actual average production cost during that year, operating at capacity, was 61.95¢ per pound (Def Ex 123; R 333). Out of a total production of 20,650,142 pounds during that year, 2,186,409 pounds of nickel were delivered to the Government at the new ceiling price of 58.77¢ per pound -- more than 3¢ per pound <u>below</u> Hanna's actual cost of production (Pl Ex 21).

The 1964 termination agreement

On November 8, 1963 the Government filed its complaint, asking, among other things, that the agreed ceiling price be reformed to an even lower figure of 57.70¢ per pound and seeking judgment on that basis for $23,395 allegedly overpaid for 2,186,409 pounds of contained nickel which had been delivered after March 31, 1961 -- despite the fact that the Government had received this nickel at a bargain price of more than 3¢ a pound less than it had cost Hanna to produce (R 6, 7). The Government's theory was that the agreed ceiling price had been based on a formula consisting of Hanna's reported 1960 production costs, less the difference between Hanna's reported 1959 and 1960 production costs, which the parties had assumed to be correct, and that it should be reformed to reflect whatever change in these figures might result from any reallocation to capital expenditures of items charged to production in 1959 and 1960, respectively.

As of March, 1964 there had been no further deliveries to the Government (P1 Ex 21). There remained 17,313,454 pounds which Hanna was obliged to deliver and which the Government was obliged to purchase. The Government preferred to accept a cash payment in lieu of delivery of the nickel. Hence a termination agreement was entered into dated March 5, 1964, under which the parties' purchase and sale obligations as to the remaining nickel under Amendment 5 were terminated and Hanna paid the Government $2,175,000, representing the approximate spread between the market and contract price for the remaining pounds. Since the Government's claim for reformation of the agreed ceiling price in

Amendment 5 was pending, it was agreed that if the court should reform the stated ceiling price of 58.77¢ downward, Hanna would pay, in addition, a sum equal to 17,313,454 times the amount of any such reduction (Pl Ex 3).

The District Court found that the "price was computed by an agreed formula which was based upon the difference between the Company's costs of production in 1959 and 1960" (R 395). On this ground, it disregarded the parties' agreement and reformed the agreed ceiling price of 58.77¢ per pound downward to 57.53¢ to reflect the reduction in Hanna's 1959 and 1960 production costs resulting from the reclassification of 38 items from production costs to capital expenditures (R 466).

b. The record proves conclusively that the parties agreed on a price, not a formula.

The following conclusions, which are required by the evidence, are dispositive of the Government's claim.

1. Hanna's proposed figure of 60¢ per pound was an estimate of its unaudited 1960 production costs, and it was used only to estimate Hanna's actual future production costs as a basis for establishing an agreed ceiling price which was to be sufficient to cover them.[9]

2. The Government wished to be protected against

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9. The ceiling price established in Amendment 4 to DMP-50 (effective November 8, 1957) was also based on estimates of costs incurred in a prior but unaudited period (Pl Ex 16, p 3; see also DMP-50, Pl Ex 1, p 7).

increases in future costs resulting from periods of low production.

3. The Government's proposal was also an estimate of Hanna's actual future production costs, which it sought to justify on the ground that it reflected Hanna's reduced costs between 1959 and 1960. The asserted "formula" was merely an argument by which the Government sought to convince Hanna that the suggested price of 58.77¢ would recover Hanna's actual future costs of production.

4. Hanna accepted the Government's proposal for a ceiling price of 58.77¢ per pound, which was well under its own proposal and far under its average actual costs during 1961, all of which would have been recovered in the price of the nickel if Amendment 5 had not been executed (Pl Ex 136, 6-D). There is no evidence or any basis for inferring that Hanna accepted a "formula."

5. The effect of the trial court's decision was to increase by 1.24¢ per pound the difference between Hanna's actual production costs of 61.95¢ per pound during 1961, when all further deliveries were made, and the below-cost ceiling price under Amendment 5 -- even though the parties had sought by Amendment 5 to secure for Hanna a price which would recover its actual production costs and merely protect the Government against paying "any more for the ferronickel to be delivered over the period of 4¼ years than it would pay were the material to be delivered over the course of the next year to 15 months

as provided in our Contract DMP-50" (Pl Ex 136, 5-D).

6. These negotiations took place in early 1961, at a time when both parties knew that Hanna's 1960 cost figures had not yet been audited as authorized by DMP-50, and as had been done theretofore for preceding years (R 208-211, 391-394). Amendment 5 does not refer to Hanna's 1960 costs or provide for recomputing the price following an audit.[10] Instead, the parties negotiated and agreed upon a flat ceiling price permitting them to avoid the uncertainties and conflict which such a procedure would have involved.

c. As a matter of law, the trial court erred in granting reformation.

1. There is no evidence supporting a finding that the parties made any agreement other than the one set forth in Amendment 5 or that they would have made a different contract if the results of the future audit and the decision of the District Court had been foreseen. Their error, if any, related only to an extrinsic fact which they assumed to be true. Reformation is not available in such a case.

> "It is not enough to justify reformation that the court is satisfied that the parties would have come to a certain agreement had they been aware of the actual facts. * * *"[11]

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10. In this respect Amendment 5 does not differ from prior amendments which set a stated ceiling price for the future which was to apply regardless of what adjustment in production costs might result from subsequent audit. See footnote 9, p 71 above.

11. Even this was not shown in this case.

* * * * *

" * * * /I/f, because of mistake as to an antecedent or existing situation, the parties make a written instrument which they might not have made, except for the mistake, the court cannot reform the writing into one which it thinks they would have made, but in fact never agreed to make."

5 Williston on Contracts (Rev Ed) 4341, 4344-4345 (§§ 1548, 1549)

"If two parties are caused to enter into a contract by reason of their common ignorance or common mistake as to some fact, but for which they would not have agreed, this may be ground for rescission, but it is not ground for reformation. Proof of such a mistake as this does not show that the parties have ever expressed assent, orally or otherwise, to any contract other than the one that is written. That writing truly expresses the only terms on which they have ever agreed. It may be subject to rescission for mistake; but there is no other agreement in accordance with which it can be 'reformed.'"

3 Corbin on Contracts (1960 Ed) 728-729 (§ 614)[12]

Similarly, in E. R. Brenner Co. v. Brooker Engineering Co., (1942) 301 Mich 719, 4 NW 2d 71 a prime contractor and a subcontractor entered into a settlement of their obligations based on a schedule of all remaining expenses and liabilities. As it turned out, however, there was an obligation to pay an additional insurance premium which was not included in the schedule. The subcontractor sued to reform the agreement to include the amount of the unanticipated premium. The court denied relief, saying:

"The parties made their contract upon the erroneous assumption that the schedule of expenses and liabilities was accurate. But there is insufficient evidence in this record to show that defendant ever agreed to reimburse plaintiff for its expenses

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12. See also 4 Pomeroy's Equity Jurisprudence (5th Ed) 1000-1001; ALI Restatement of Contracts, § 504 (comment c); Patterson: Relief for Unilateral Mistake, (1928) 28 Col L Rev 859 at 900-904.

> and liabilities irrespective of the amount. * * * the parties never contemplated that there would be an additional insurance premium liability. * * * In the record before us there was at best only a mutual mistake as to an extrinsic fact. * * * If the mistake is with respect to an extrinsic fact, although one which probably would have caused the parties to make a different contract, reformation will not be allowed, because courts cannot make a new contract for the parties."
>
> (4 NW 2d at 73)

Maryland Casualty Co. v. United States, (CCA 8 1948) 169 F2d 102 was an action by a subcontractor to recover for labor furnished to the prime contractor in the construction of a military facility. He recovered judgment, and the prime contractor appealed, contending that the unit prices provided in the subcontract were the product of a mutual mistake as to the Government's payment obligations under the prime contract. The court denied reformation:

> " * * * Even if it could be said from the evidence, as certainly it can not, that both King and Briggs entered into the contract sued on in the mistaken belief that the Tertelings would receive 80 cents a cubic yard for the construction of the 9 inch subbase unconditionally and in all events, the result would be only to show that they were mistaken as to a fact assumed by them to be true. But this would not justify the court under the evidence in the present case in writing for them a contract which clearly they did not write. * * *"
>
> (169 F2d at 112)

In Russell v. Shell Petroleum Corporation, (CCA 10 1933) 66 F2d 864 the defendant negotiated an oil lease on the mistaken assumption that the lessor owned only the south half of a certain parcel of land. The lease was drawn to cover only the south half of the property. In fact, the lessor owned a part of the north half as well. The court denied relief, describing the case as

one in which

> " * * * a mistake as to facts extrinsic to the oral negotiations and the contract led Kirkbride to make a contract which he would not have entered into had he understood the true facts, but the contract as written was exactly as he intended it to be; it expressed the very terms he intended."
>
> (66 F2d at 866)

> "To justify reformation on the ground of mistake, the mistake must have been made in the drawing of the instrument and not in the making of the contract which it evidences. * * * A mistake as to the existing situation, which leads either one or both of the parties to enter into a contract which they would not have entered into had they been apprised of the actual facts, will not justify reformation. It is not what the parties would have intended if they had known better, but what did they intend at the time, informed as they were."[13]
>
> (66 F2d at 867)

In Power Service Corporation v. Joslin, (CA 9 1949) 175 F2d 698 at 704 this Court said:

> "We have previously indicated our disagreement with any assertion that the Corporation rightly assumed that the shortages were less than they actually were. But assuming a mistake existed, and that both parties made it, it is not such a mistake as warrants reformation. There was no mistake as to the language of the contract and the specifications. Nothing intended to be inserted was omitted by mistake. The mistake, if any, related to how much of the materials was on hand. Such a situation does not warrant reformation."[14]

2. The parties to Amendment 5 knew in March, 1961 that Hanna's 1960 cost figures had not been audited. They also knew that the Government was entitled to audit them and would do

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13. The court also denied relief on the additional ground that the mistake was not mutual.

14. See also Rock-Ola Mfg. Corp. v. Filben Mfg. Co., (CCA 8 1948) 168 F2d 919 at 923.

so, as it had consistently done before. The parties were ignorant -- and knew they were ignorant -- of the results of that future audit, and they made their agreement without reference to it and without regard to those results. Their agreement for a flat ceiling price of 58.77¢ per pound entered into on that basis cannot be reformed. In Harley v. Magnolia Petroleum Co., (1941) 378 Ill 19, 37 NE 2d 760 at 765 the court said:

> "* * * /W/here the parties to an agreement enter into it in the face of their conscious present want of knowledge of facts, which they all thus manifestly conclude would not influence their action or induce them to refrain from entering into the agreement, whatever the facts might be, there is not such mistake of fact as to constitute ground for reformation of the agreement. * * *"[15]

The Government's claim does not proceed on the basis that the parties intended to fix a price, but instead that they intended the agreed ceiling price to be open for redetermination after audit, a conclusion which is wholly unsupported by the evidence and is contradicted by the terms of Amendment 5, which provides only for the flat ceiling price which had been negotiated between them.

Nor is it consistent with the purpose of the Amendment. Hanna's costs in 1961 and any future years of actual production which would govern if lower than 58.77¢, were obviously unknown as of March, 1961, and were intended to be a variable. The ceiling price of 58.77¢ per pound, by contrast, was fixed. The two together gave the Government the protection it sought. The Government, by its present claim, would rewrite the contract to

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15. See also Almer Coe and Co. v. American Nat. B. & T. Co. of Chicago, (1963) 44 Ill App 2d 104, 194 NE 2d 14 at 16-17; Anno: 137 ALR 908 (1942).

make both factors variable. It would impose, instead of the agreed ceiling price, a formula based upon (a) whatever 1960 costs might prove to be after audit and (b) whatever 1959 costs might prove to be after reaudit (Hanna's 1959 costs had been audited before Amendment 5 was signed, see R 209A). This, however, is not what the Amendment says. The Amendment makes no reference whatsoever to any formula, or to 1959 costs, or to 1960 costs, or to any audit or reaudit. It simply provides that the ceiling price shall be 58.77¢.

3. The Government's asserted formula (1960 costs minus the difference between 1959 and 1960 costs) happens to result in a net gain to the Government -- since nearly all of the items successfully challenged by the Government were paid for in 1960. However, the mathematical effect of the Government's "formula" is that a reduction of 1959 costs operates to raise the ceiling, while a reduction of 1960 costs, where most of the Government's claim lay, operates to lower the ceiling.[16] If a reaudit of 1959 costs had operated to reduce costs for that year and 1960 costs had remained the same, the Government, under its formula theory, would owe money to Hanna. We can only speculate as to whether in that situation the Government would argue, as it now does, that the agreed ceiling price was not a fixed figure but a formula whose components could only be ascertained at some future time.

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16. Of the 216 items which the Government finally submitted, 24 items costing $135,800.04 were paid for in 1959, and 17 items costing $215,768.60 were paid for in 1960 (Pl Ex 170, 174).

4. The burden of persuasion necessary to support a decree of reformation is an unusually heavy one. Such a decree must be based on evidence

> " * * * that is plain and convincing beyond reasonable controversy * * *. A mere preponderance of the evidence is not sufficient. * * *"
>
> Maryland Casualty Co. v. United States, supra, (CCA 8 1948) 169 F2d 102 at 112 (and cases there cited)[17]

To sustain this decree, there must be plain and convincing evidence that the parties did not in fact agree upon a ceiling price as set forth in Amendment 5, but rather upon a formula for determining a price and that the true contract was for whatever ceiling price that formula might produce. The evidence must be plain and convincing to show that the parties so far relied on the formula that Hanna would have accepted a ceiling price of 57.53¢ per pound if the Government had offered it, based on the "formula," during the negotiations. The evidence must be plain and convincing that the parties agreed that the ceiling price would be subject to adjustment upon final audit. Finally, the evidence must be plain and convincing that the parties intended these things to be a part of their agreement in Amendment 5. In fact, none of these is shown or supported in the record. There is no evidence that anything intended to be put into or to be a part of Amendment 5, which was long and carefully negotiated by skilled Government negotiators, is not there. The error, if any, was not in the terms of the contract, but as to the circumstances surrounding the making

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17. See also Moyer v. Title Guaranty Company, (1962) 227 Md 499, 177 Atl 2d 714 at 715-716 (requiring "proof of the highest order"); Hayes v. Travelers Ins. Co., (CCA 10 1937) 93 F2d 568 at 571.

of it. Reformation is not an available remedy in such a case.

d. The gross inequity of the trial court's decision to reform the agreed ceiling price must be emphasized. The record makes clear that the purpose of the ceiling, from the Government's viewpoint, was to avoid paying more by reason of the extended delivery schedule than it would have paid if deliveries had been made under the original contract terms. Hanna's actual production costs at full production proved to be 61.95¢ -- substantially higher than expected. The trial court, however, reformed the agreed ceiling price downward to reflect a purely extrinsic and collateral circumstance.

> "The reformation of instruments is purely an equity remedy and its every application must lead to equitable results. * * *"
>
> M. T. Straight's Trust v. Commissioner of Internal Rev., (CA 8 1957) 245 F2d 327 at 329

If the record suggests anything about an agreement concerning costs, it is that the parties would have agreed on 61.95¢ if they had known that this is what Hanna's average actual costs of production of delivered nickel would be. The Government, having had full protection against Hanna's higher production costs during the delivery period, now seeks to increase the spread between those costs and the contract price of delivered nickel and increase Hanna's payment obligations under the termination agreement. The District Court's decree of reformation was inequitable as well as wrong, and it should be reversed.

II.

The District Court abused its discretion and erred in awarding prejudgment interest.

In actions to recover money due the Government at a fixed time, interest can be awarded from the due date as damages for delay. Royal Indemnity Co. v. United States, (1941) 313 US 289 at 295-296. This, however, as applied to actions to recover money improperly paid, is a rule of limited application.

> " * * * The cases teach that interest is not recovered according to a rigid theory of compensation for money withheld, but is given in response to considerations of fairness. It is denied when its exaction would be inequitable. * * *"
>
> Jackson County v. United States, (1939) 308 US 343 at 352

In this case, the District Court allowed prejudgment interest on overpayments which it found the Government had made for nickel on the ground that the cost of each of the 38 reallocated items was undisputed and the company "had the use" of the Government's money during the prejudgment period (R 467).

The circumstances recited by the court are insufficient on this record to support the allowance of prejudgment interest, and the court abused its discretion in awarding it.[18]

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18. Hanna contends that the record does not support any award of prejudgment interest; alternatively, that the trial court erred as a matter of law in allowing interest for a period prior to the Government's demands for reimbursement (p 86 below).

a. The amount found to be owing was an unliquidated fraction of the Government's claim, and at no time could Hanna calculate and tender the amount of its indebtedness.

Prejudgment interest is disallowed on claims whose amounts are essentially incapable of ascertainment before trial, in the absence of circumstances making such award "necessary" as an element of damages. Miller v. Robertson, (1924) 266 US 243 at 258.[19] None have been suggested in this case.

The Government's claim for reimbursement was not in any realistic sense liquidated. It was asserted from time to time commencing March 14, 1962 in varying -- but always increasing -- amounts. While the amount of money involved in most (but not all) of the 284 items was known, the Government's objections to 246 items constituting more than 85% of its dollar claims were either abandoned or disallowed. The Government's good faith in preparing and prosecuting this action is in substantial doubt, for it abandoned its objections to 68 items totalling more than $346,000 on the very day of the July trial,[20] after Hanna had been put to the trouble and expense of preparing to defend against them (R 334, 378; July Tr 7, 37). In short, an

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19. See also Southern Painting Company of Tenn. v. United States, (CA 10 1955) 222 F2d 431 at 435:

> " * * * Obviously, it would be unfair and inequitable to exact interest when the amount of an asserted claim is in dispute in good faith and could not be determined until after a judicial inquiry and sifting of all the facts."

20. The equitable defenses were segregated and tried on October 2-3, 1964. The remaining issues were tried on July 20-22, 1965.

indiscriminate and oppressive claim for nearly $2,000,000 was substantially defeated, and Hanna's accounting decisions and practices were substantially approved by the trial court.

Not only was the Government's claim grossly overstated; it consisted of a host of items requiring detailed accounting treatment under varying accounting principles, as to all of which there was extensive expert testimony by eminent accountants, and at no point prior to a judicial sifting of this long and complex record could Hanna have determined what it owed. The Government's claim was not for a fixed amount due. The amount owing was incapable of ascertainment, and it was inequitable and wrong to treat the claim as one for a fixed amount.

In Lundgren v. Freeman, (CA 9 1962) 307 F2d 104 at 111-112 this Court reversed an award of interest on the net amount found by arbitrators to be owing a contractor on disputed billings. The question under applicable Oregon law was whether the amount of the claim was ascertainable. Judge Duniway held that it was not:

> " * * * Cross demands and claims by Lundgren and school district, as to many disputed items, were submitted to the arbitrators. Many were allowed; many more were not. It cannot fairly be said that the net amount due Lundgren was ascertained or ascertainable until the arbitrators made their award."

In United States v. Campbell, (CA 9 1961) 293 F2d 816 at 819-820 a claim under the Miller Act was held to be uncertain in amount in a case which arose from differences of opinion over proper accounting practices under an equipment lease. The

lessor had asserted excessive claims for equipment rental against the lessee's sureties. The Court, by Judge Barnes, said:

> " * * * The court, in the instant case, held that the amount claimed was in dispute and uncertain because plaintiff sought, in each complaint, rental in excess of any possible amount that it was entitled to recover. Appellant counters that it had no choice but to claim the full amount of unpaid rent against both sureties for it then had no access to the records of the subcontractor and therefore no basis for allocating the rental charges between the two jobs. Whatever the reason behind appellant's position may be, it is clear, in view of the hot dispute over the proper principle of allocating the rent already paid, that the amount due appellant could not be made certain by mere calculation. The court was correct in refusing interest on the ground that the claim was unliquidated * * *."[21]

Hanna's indebtedness was only a small part of a large and complicated claim, a substantial part of which should never have been asserted and was abandoned at the commencement of the second trial. The balance of the Government's claim was vigorously, and, in major part, successfully resisted. Allowance of prejudgment interest on the relatively small part of this wholly indefinite obligation as to which the Government prevailed was a harsh and inequitable imposition.

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21. See also Carlstrom v. Agricultural Ins. Co., (CA 9 1950) 180 F2d 286 (interest disallowed under California law where amount due on insurance claim was incapable of calculation because claim was grossly overstated).

b. The Government benefited, at no cost to it, from the reclassified expenditures on which the District Court allowed interest.

The six major items of expenditure which the court reclassified as capital expenditures accounted for $215,109.90 of the total of $231,506 awarded with respect to all reclassified items (R 388-389, 465, 468). All of the disputed items reduced costs or were essential to the continued operation of the plant (Oct Tr 46-47, 58). Substantial cost savings to the Government resulting from the acquisition of items reclassified by the trial court were shown by Hanna's uncontradicted evidence (Oct Tr 50-52; Def Ex 110).

Hanna was not obligated under the contract to install these items, for which the Government thereafter insisted Hanna must not be reimbursed, and it is grossly inequitable that the benefit conferred upon the Government at Hanna's expense as a result of the District Court's ruling on the merits should be compounded by the award of prejudgment interest. The Government has already received the benefit of Hanna's use of the money.

Swift & Company v. United States, (CA 4 1958) 257 F2d 787 at 796, cert den (1958) 358 US 837

Land O'Lakes Creameries, Inc. v. Commodity Credit Corp., (CA 8 1959) 265 F2d 163 at 166

III.

The District Court erred in allowing interest for a period prior to the Government's demands for reimbursement.

Even if (which Hanna denies) this was a case in which the trial court could award prejudgment interest at all, the amount which it allowed was grossly excessive. The District Court expressly found that there was no evidence that Hanna acted wrongfully or failed to make its accounting decisions and practices known to the Government (R 395). Consequently, Hanna's receipt of the money was not wrongful, and its obligation to repay it did not arise until the Government demanded reimbursement of amounts which the trial judge allowed. Interest does not commence to run until payment is due,[22] and it follows that the District Court erred in awarding interest for a period prior to those demands.

The six major items of expenditure which the District Court reallocated to capital expenditures were as follows:

Item	Description	Amount
131	Sawdust System	$ 92,832.80
107/123	Pig Casting Machine	56,185.68
106/122	Microdyne Wet Dust Collectors	37,816.42
130	Scoopmobile	28,275.00
	TOTAL	$ 215,109.90

(Pl Ex 175, p 1, Category 1a)

Of these items, all but 106/122 (the dust collectors)

22. McCormick on Damages (1935) 229 (§ 58); ALI Restatement of Contracts, § 337.

were included in the Government's demand for $210,605 which Hanna received on March 16, 1962 (Def Ex 125; see also Pl Ex 23, p 1).[23]

The larger billing for $252,147 which Hanna received on July 13, 1962 included the same items and claimed, for the first time, reimbursement of part of the price paid for nickel delivered after March 31, 1961 (Pl Ex 23).[24] The claim for the dust collectors (Items 106/122) and the minor items was first asserted in the Government's itemized bill for an additional $1,564,811 which Hanna received on January 28, 1963 (Pl Ex 61).[25]

If prejudgment interest is properly allowable at all (which Hanna denies), interest on each item of the award commenced only when it was demanded by the Government. Thus, interest on the amount allowed for the dust collectors ($37,816.42) and the minor items ($16,396.38) commenced on January 28, 1963 and amounted to $10,551.22 on April 27, 1966, the date of the judgment; interest on the award for partial reimbursement of the price of nickel delivered after March 31, 1961 ($27,111.49) commenced on July 13, 1962 and amounted to $6,163.46; and interest on the award for the remaining items ($177,293.48) commenced on March 6,

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23. The dollar amounts of that claim were slightly different from the figures set forth in Pl Ex 175, and it included claims for additional items which were thereafter abandoned or reclassified in other categories.

24. This claim, which was for $41,542, was excessive; only $27,111.49 was allowed by the District Court (R 466).

25. By the time of trial, this figure had been adjusted. See p 97, fn 31 below).

1962 and amounted to $43,773.55. If prejudgment interest could be allowed at all, it could be calculated only from those demand dates in a total amount, down to April 27, 1966 (the date of the judgment), of $60,488.23.

The District Court found that "there is no evidence that the Company acted wrongfully or failed to make its accounting decisions and practices known to the Government" (R 395). In the absence of bad faith or fraud,[26] Hanna's possession of the funds was not wrongful prior to the Government's demands. The obligation to reimburse the Government did not mature, and interest could not commence to run before those dates. Washington Ry. & E. Co. v. Washington, B. & A. Electric R. Co., (CA DC 1929) 32 F2d 406 was an action to recover sums which the defendant, "owing to oversight or misinterpretation of the contract," had incorrectly billed to the plaintiff with respect to fares of passengers transferred between the two lines. The defendant's erroneous accounting method had been accepted by both companies until the mistake was discovered. The court held that the trial court correctly computed interest from the date of the plaintiff's demand for reimbursement. It applied the rule that

> "' * * * when a mutual mistake occurs between the payer and receiver of a sum of money, by which the whole has not been paid, or too much has been received, interest is not recoverable on the sum so withheld or received, unless it has been unjustly withheld or unjustly received. The party retaining the money by mistake, may well rely on the acquittance received

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26. That guilty knowledge or a fraudulent purpose can justify an award of interest from the date of payment, see United States v. United States F. & G. Co., (1915) 236 US 512; United States v. Rodiek, (CCA 2 1941) 120 F2d 760.

or given, until the injured party makes known his claim and demands correction and payment. After such demand, if it be refused, and it turns out that there was money due which ought to have been paid, it will bear interest from demand until paid.' * * *"

(32 F2d at 410)

In Reconstruction Finance Corp. v. Service Pipe Line Co., (CA 10 1953) 206 F2d 814 it was claimed, following an audit, that oil subsidies had been improperly paid to the defendant. The court held that the obligation was one which matured only on demand.

" * * * If the determination of the governmental agency is invalidated, the question of interest will be moot. If, however, the determination is upheld, the Pipe Line Company has had the use of the government's money under an expressed and implied promise to return it upon demand. That demand was made on October 18, 1946, and it follows that in justice and fairness, the Pipe Line Company should pay just compensation for the use of the money during the time it was erroneously withheld. * * *"

(206 F2d at 818)

In Schindler v. Ross, (1958) 182 Kan 227, 320 P2d 813 at 819 the court said:

" * * * This, as we have previously indicated, was an action on implied contract to recover money paid under a mistake of fact. Moreover, it is clear from the record, in fact the trial court found, that at the time of receiving the involved payments the appellant did not know she was being overpaid. The general rule, which we believe to be sound and to which we therefore adhere, is that where money has been paid and received through mutual mistake of fact, without fraud or misconduct on the part of him to whom the money was paid, interest does not begin to run and will not be allowed until the mistake has been discovered and demand for repayment made. * * *"[27]

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27. See also LaParr v. City of Rockford, Ill., (CCA 7 1938) 100 F2d 564 at 568-569; 87 ALR 649 at 652 (1933); 5 Williston on Contracts (Rev Ed) 3943 (§ 1415).

The award of interest was improper in its entirety, for reasons set forth above (pp 81-85). Separately, the inclusion of interest for a period prior to the Government's demands for reimbursement ($26,840.34 of the total sum awarded) was erroneous as a matter of law, because there was no indebtedness or wrongful refusal to pay until Hanna received the Government's demands.

CONCLUSION

The District Court erred in reforming the agreed ceiling price in Amendment 5 and there is no factual or legal decision for concluding that the parties did not agree upon a price but instead upon a formula. The District Court abused its discretion and erred in allowing prejudgment interest. The judgment in favor of the Government should be reduced to $231,506.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of the foregoing brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

_____

Attorney

TABLE OF EXHIBITS

(Pursuant to Rule 18(2)(f))

EXHIBIT	IDENTIFIED	OFFERED AND RECEIVED
Plaintiff's Exhibits		
1 through 80	R 246-249	Oct Tr 3-4
82 through 178	R 315-318	July Tr 2
179	July Tr 235	July Tr 235
Defendants' Exhibits:		
1 through 110C	R 241-245	Oct Tr 3
113 through 130	R 324	July Tr 2

APPENDIX A

Contract Provisions Material to the Dispute[1]

Article IV:

Article IV (entitled "Facilities"), as amended by Amendments 3 and 4:

> "With advances made by the Government as provided in Article VI, the Contractor will construct and equip * * * a facility for the conversion of ore from the mine into saleable ferronickel. The period * * * to and including December 31, 1954 is hereinafter called the 'Break-In Period.' During the period beginning January 1, 1955 and ending * * * not later than September 30, 1955 /hereinafter called 'Period 1'/ the facility shall consist of one electric refining furnace, two electric melting furnaces, one electric ferro-silicon furnace, one electric slag melting furnace, a slag-disposal site and equipment, a stockpile site and stockpiling equipment, a sewage-disposal plant, railroad spurs, housing for personnel, preliminary construction and foundations for two additional electric melting furnaces and facilities as may be required after Period 1 /not later than September 30, 1955/, and all equipment and facilities agreed to by the Government as necessary for such conversion of ore from the mine into saleable ferronickel. * * * The facility, as it exists from time to time as contemplated by this Article or as it may be substituted for from time to time with the approval of the Government, is hereinafter called 'the Facility.'"

Article VI:

Paragraph 1 of Article VI (entitled "Advances"), as amended by Amendments 3 and 4:

> "Upon the Contractor's written request, the Government will make advances (hereinafter called 'Capital Advances') of the entire amount up to a total of $22,875,000 * * * required * * * (b) to construct, equip, design and rebuild the Facility contemplated by Article IV (including all costs and expenses of every

1. These provisions are those relied on by the Government (R 205-208).

nature arising from operations or otherwise during * * * the Break-In Period * * * and including all costs and expenses incurred * * * within Period 1 * * * when both electric melting furnaces are shut down by reason of constructing, equipping, designing, rebuilding or repairing said furnaces or related equipment * * * (c) for such replacements or improvements of the Facility which are agreed by the Contractor and the Government to be necessary or advisable * * * and (d) for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized. * * * As soon as practicable after the end of each calendar month, the Contractor will submit to the Government a cumulative statement of the cost of the Facility in such detail as the Government may reasonably request."

Paragraph 2 of Article VI (entitled "Advances"), as amended by Amendments 3 and 4:

"Upon the Contractor's written request * * * the Government will advance to the Contractor sums (hereinafter called 'Working Capital Advances') representing its reasonable minimum working capital requirements so long as the sum of such request plus Working Capital Advances then outstanding does not exceed $3,750,000. * * * Working Capital Advances may be requested and used by the Contractor to pay any costs and expenses hereunder of the Contractor including costs arising from the payment of tax liability or other source, not covered by Capital Advances and which are in excess of funds then available from the sale hereunder of ferronickel at the prices herein set forth."

Paragraph 3 of Article VI (entitled "Advances"), as amended by Amendment 3:

"Capital Advances and Working Capital Advances shall be kept in separate accounts at a bank or banks approved by the Government; shall not be commingled with each other or with other funds; shall bear interest at 5% * * *; shall be evidenced by a note or notes * * *; and shall be secured as in Article XVIII provided. Interest on Capital Advances * * * shall be added to the amount of Capital Advances * * *."

Article VIII:

Paragraph 1 of Article VIII (entitled "Sale and Purchase of Ferronickel"), as amended by Amendments 3 and 4:

"The Contractor will sell to the Government and the Government will purchase from the Contractor, all saleable ferronickel produced by the Facility during the period of this contract up to a maximum of 125,000,000 pounds of contained nickel in ferronickel * * *, the price per pound of contained nickel shall be determined by adding (a) the Contractor's actual cost of production per pound of contained nickel (but not more than 75¢ escalated as hereinafter provided * * * and (b), but only in the case of the first 95,000,000 pounds of contained nickel in ferronickel produced after the beginning of Period 1 and sold to the Government, an amount per pound of contained nickel (hereinafter called 'Amortization Payment') sufficient to amortize the Capital Advances made pursuant to Article VI plus interest thereon. * * * The Contractor's actual cost of production included in the price for ferronickel sold hereunder shall never exceed the applicable ceiling fixed above, as escalated, but subject to such applicable ceiling, shall mean and include (a) until the end of the three year period from the calendar quarter commencing closest to the beginning of Period 3, all theretofore unrecovered costs and expenses hereunder of the Contractor (including any previous overrun of costs of production over the then applicable ceiling) not covered by Capital Advances and which arise from operations, payment of royalties, management and consultants' fees, insurance, interest on Working Capital Advances, state and local taxes, or other sources, excluding federal income taxes and (b) thereafter, for each running period of three consecutive years, only such costs and expenses (but not including any overrun of costs of production over the then applicable ceiling) as are incurred during or with respect to such three year period. * * *"

APPENDIX B

Analysis of Trial Court Judgment (R 468-469)

Judgment items disputed by Hanna on cross appeal:

Prejudgment interest on $231,506.00 awarded as overpayment for nickel delivered under DMP-50	$ 79,603.87	
Prejudgment interest on $27,111.49 awarded as overpayment for 2,186,409 pounds of nickel delivered under Amendment 5	7,724.70	
Amount awarded on reformation claim as overpayment for 2,186,409 pounds of nickel delivered under Amendment 5	27,111.49	
Additional payment under termination agreement for release of 17,313,454 pounds of nickel, based on reformation of purchase price in Amendment 5	214,686.83	
	$ 329,126.89	$ 329,126.8

Judgment items not disputed by Hanna on cross appeal:

Amount awarded with respect to 38 items reallocated to capital expenditures from cost of production of nickel delivered under DMP-50 prior to Amendment 5	$ 231,506.00	$ 231,506.0
TOTAL AMOUNT OF JUDGMENT		$ 560,632.9

APPENDIX C

Statement of the Facts

This litigation arises out of Contract DMP-50 (Pl Ex 1) dated January 16, 1953 between plaintiff United States, acting by and through the Defense Materials Procurement Agency (DMPA)[1] and defendant Hanna Nickel Smelting Company. That contract was one of three related contracts between DMPA and subsidiaries of The M. A. Hanna Company under the Defense Production Act of 1950, as amended (50 USC App § 2061), to expand the nation's productive capacity for nickel and the domestic supply of nickel available to the United States (R 215-216; Def Ex 82, pp 1-2).[2] Plaintiff sued to recover $1,739,328[3] which it claimed was improperly included in the price of nickel purchased from Hanna under the contract before it was terminated on March 5, 1964.[4] It also

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1. In August, 1953, DMPA was abolished and its functions were transferred to General Services Administration (GSA), and particularly to a subdivision of GSA then known as Emergency Procurement Services (EPS) and now as Defense Materials Services (DMS) (R 214).

2. The other contracts were with defendant Hanna Coal & Ore Corporation, whose name was changed to The Hanna Mining Company in 1958 (R 214, 216). It is referred to herein as "mining company."

3. See R 3-4; this figure was reduced to $1,738,598 in the supplemental pretrial order (R 304); it was further reduced to $1,392,377 at the commencement of the second trial, when the Government abandoned $346,222 of its claim (R 334, 378; Pl Ex 170; July Tr 37, 40, 49).

4. Plaintiff also sought interest from the respective dates of overpayment (R 6; Pl Ex 170). An additional claim for $54,235 asserted in Count 2 of the complaint was paid and was dismissed before the second trial (R 299-300).

sought an additional $23,395[5] through reformation of the agreed ceiling price for nickel contained in an amendment to the contract applicable to nickel delivered in 1961 and a reduction in the price of the balance of nickel to be delivered under the contract (R 5-7, 305-306).

The three contracts were as follows:

1. Contract DMP-49 provided that the mining company would open and develop a nickel bearing ore deposit at Riddle, Oregon, and sell ore mined from the deposit to the Government at a fixed base price (R 216; Def Ex 82, p 13).

2. Contract DMP-50 provided that the smelting company, with money advanced by the Government, would construct and operate a smelting facility at Riddle, Oregon using an experimental French refining process. It agreed to purchase ore from the Government for the price the Government had paid the mining company, process the ore and deliver up to 125,000,000 pounds of contained nickel in ferro-nickel to the Government by June 30, 1962 at a price consisting of the cost of production (including cost of ore) and, over the first 95,000,000 pounds only, an additional amount sufficient to amortize the capital cost of the facility with interest (R 216; Def Ex 82, pp 13-14). This litigation arises out of a dispute over the cost of production factor to be included in the price paid by the Government.

3. Contract DMP-51 provided that the mining company

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5. See R 5-6, 305-306; this claim was increased to $27,986 when the case was submitted (R 379).

would sell the Government's nickel, if the Government ever requested it to do so, to industrial users on a commission basis at rates set by the Government and that the mining company guaranteed the financial obligations of the smelting company under DMP-50 (R 216, 299; Def Ex 82, pp 14-15). The mining company was joined as a defendant on the obligation of that guarantee (R 6). Neither DMP-49 nor DMP-51 is otherwise involved in this litigation.

Under these contracts, commercial production facilities were constructed which by 1958 had an annual capacity of more than 20,000,000 pounds of contained nickel (Def Ex 82, p 17).

The Terms of DMP-50

Under DMP-50, the Government agreed to provide capital advances to the smelting company up to a total of $22,000,000 (Article VI).[6] It also agreed to advance working capital requirements on a revolving fund basis up to a maximum balance at any time of $2,800,000 (Article VI).[7]

Capital advances were to be made

> " * * * (a) to test the process as provided in Article II, including the cost of mining and of shipping to France the quantity of ore from the Mine required for such tests and including the reasonable

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6. All references are to provisions of DMP-50 which is in evidence as Pl Ex 1. An additional $875,000 was authorized by Amendment 4, executed as of September 30, 1957 (Pl Ex 16, p 2); however, only $300,000 of this was ever requested by Hanna or advanced by the Government, and Hanna returned $27,444 of this amount (R 298).

7. This figure was increased to $3,750,000 by Amendment 4 (Pl Ex 16, p 2).

> expenses of technical observers to attend such tests on behalf of the Contractor, (b) to construct, equip, design and rebuild the Facility contemplated by Article IV (including all costs and expenses incurred during or in respect of any periods of time within Period 1 that production of salable ferro-nickel has ceased by reason of constructing, equipping, designing, rebuilding or repairing the furnaces or related equipment), (c) for such replacements or improvements of the Facility which are agreed by the Contractor and the Government to be necessary or advisable during the period of this Contract, and (d) for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized. * * *"
>
> (Art VI(1))

Working capital advances, representing the contractor's "reasonable minimum working capital requirements," were defined as follows:

> " * * * Working Capital Advances may be requested and used by the Contractor to pay any costs and expenses hereunder of the Contractor, including costs arising from the payment of tax liability or other source, not covered by Capital Advances and which are in excess of funds then available from the sale hereunder of ferro-nickel at the prices herein set forth."
>
> (Art VI(2))

Both classes of advances were evidenced by notes of the smelting company bearing 5% annual interest on the unpaid balances and were secured by a mortgage of the entire facility, including the real property (Arts VI, XVIII).

The smelting company agreed to buy, at the Government's cost, ore purchased by the Government from the mining company under DMP-49 (Art VII). The Government agreed to purchase all salable ferronickel produced from the ore up to 125,000,000 pounds of contained nickel at a price equal to the cost of production plus an amount (payable over the first 95,000,000 pounds

only) sufficient to amortize capital advances and interest. The cost of production was defined to

> " * * * mean and include (a) until the end of the three year period from the calendar quarter commencing closest to the beginning of Period 3, all theretofore unrecovered costs and expenses hereunder of the Contractor (including any previous overrun of costs of production over the then applicable ceiling) not covered by Capital Advances and which arise from operations, payment of royalties, management and consultants' fees, insurance, interest on Working Capital Advances, state and local taxes, or other sources, excluding federal income taxes and (b) thereafter, for each running period of three consecutive years, only such costs and expenses (but not including any overrun of cost of production over the then applicable ceiling) as are incurred during or with respect to such three year period. * * *"
>
> (Art VIII)

The cost of production component of the price was subject to an agreed ceiling which was to be reduced from 79.39¢ per pound to 60.5¢ per pound after delivery of the first 5,000,000 pounds, and to escalation upward or downward, based on Labor Department and other indices (Art VIII).

The contract contemplated the use of a new and untried refining process, and it provided for a preliminary period of experimentation and testing during which all costs and expenses would be paid for from capital advances (Arts II, VI). Production operations under the contract were to be conducted in three phases (Art IV): Period 1, which was to commence upon completion of the initial facility no later than September 30, 1954 and end on or before September 30, 1955, when Hanna should make its preliminary

determination of technical feasibility;[8] Period 2, which was to end on or before March 31, 1956, when Hanna should make its final determination of technical feasibility; and Period 3, the balance of the contract period. The contract was to end on June 30, 1962, or when 125,000,000 pounds of nickel should be delivered to the Government (Art XIV).[9]

The contract required that the facility be operated at the maximum practicable rate during Period 2 (Art V); additional equipment was to be installed during that period (Art IV), and the facility was to operate during Period 3, following Hanna's final determination of technical feasibility, at the maximum practicable rate, with minimum annual production of 13,720,000 pounds of contained nickel and minimum total production of 95,000,000 pounds over the life of the contract (Art V).

The contract could be terminated by Hanna (a) at any time upon payment of the unpaid balance of the Government's advances, with interest, plus a "residual payment" equal to 7½% of capital advances (excluding capital replacements), the company retaining title to the smelting facility; (b) if the Government

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8. Technical feasibility was defined as the smelting company's estimate that the facility was capable of converting ore into salable ferronickel in the quantities required by the contract at costs not in excess of applicable contract ceiling prices (Art I). Production during Period 1 was to be subject to any further necessary testing of the process and modifications of the facility (Art V).

9. These dates were modified by amendments to the contract. The beginning of Period 1 was extended to January 1, 1955 (Pl Ex 2, p 2) and the end of Period 2 was extended to September 30, 1957, when Hanna was able to make its final determination of technical feasibility (Pl Ex 16, p 2).

breached either the mining or the smelting contract, in which case Hanna could either convey the facility and all of its assets to the Government and have its liability for advances and interest cancelled, or repay the balance of the advances and interest, together with the residual payment, and retain title to the smelting facility; or (c) if Hanna determined prior to prescribed dates that the process was not technically feasible, in which case Hanna was required to convey the facility and all of its assets to the Government in exchange for cancellation of its liability for advances and accrued interest (Art XIV).

Operations under DMP-50

The smelting facility was built under a subcontract with Bechtel Corporation. Initial construction commenced in 1953 and continued during 1954 and 1955. Production commenced on a limited basis in August, 1954; however, the plant was not brought to regular production until 1955 or to full productive capacity until early 1956. The delay was caused by the need for an extensive period for testing the feasibility of the smelting process in accordance with the contract (R 217; Def Ex 82, pp 16-17). However, production increased in the following months, and by 1958 the facility was producing contained nickel at an annual rate of over 20,000,000 pounds (Pl Ex 21; Def Ex 82, p 17). By the end of September, 1960, 95,327,000 pounds of contained nickel had been sold to the Government, and the capital advance amortization factor in the price paid by the Government ceased to apply (Def Ex 82, p 17).

The General Accounting Office report issued in April,

1961 concluded that the

> " * * * terms of the contract were consistent with the applicable legislation and that the purpose of the contracts has been fulfilled."
>
> (Def Ex 82, transmittal letter, p 1)

Although Hanna sought effectively and in good faith to reduce the cost of production (Oct Tr 94), the process was essentially experimental, and thus by the end of 1956 Hanna had incurred losses on smelting operations under the cost of production ceiling o 60.5¢ amounting to more than $1,900,000 (Pl Ex 17, p 8; Def Ex 82, p

By Amendment 4, dated November 8, 1957, the ceiling price, exclusive of escalation, was increased to 75¢ per pound, which allowed Hanna to recover these losses on subsequent deliveries and, having done so, to operate thereafter on a break-even basis. The amendment also increased the ceiling for capital advances by $875,000 to $22,875,000 and recited Hanna's favorable final determination of technical feasibility on September 25, 1957 (Def Ex 82, pp 18-19; Pl Ex 16; R 219).

By April 20, 1961, when Amendment 5 was executed, total capital advances under the contract amounted to $22,300,000 and working capital advances of $69,945,000 had been made; all of these advances, including interest, had been repaid or otherwise liquidated, except $1,051.44, which was thereafter paid by Hanna. Some $575,000 of authorized capital advances was never requested by Hanna or advanced by the Government, and Hanna refunded $27,444 of unused capital advances, with interest, to the Government (R 298; Pl Ex 87, 88).

As of March 31, 1961, the effective date of Amendment 5,

Hanna had delivered 105,500,137 pounds of nickel to the Government (R 298), which left a balance of 19,499,863 to be delivered by June 30, 1962, when the contract would terminate according to its terms.

Under Amendment 5 Hanna made a negotiated residual payment to the Government of $1,721,653 to discharge the mortgage on the smelting plant, and it was agreed that the remaining 19,499,863 pounds of nickel would be delivered by June 30, 1965 at a price per pound which would repay Hanna's average actual cost of production per pound of contained nickel delivered in each calendar year, not to exceed a ceiling price of 58.77¢ per pound (Pl Ex 59; R 217, 298-299). Between March 31, 1961 and January 1, 1962 Hanna delivered 2,186,409 pounds of nickel (R 299; Pl Ex 21). Its average actual production costs during that period were 61.95¢ (Def Ex 123; R 333); consequently, Hanna was paid only the contract ceiling price of 58.77¢ for those deliveries (R 299).

In March, 1964, in light of the fact that the market price of ferronickel was substantially above the contract ceiling and the Government no longer needed to add ferronickel to the stockpile (Def Ex 98, p 2), Hanna paid the Government the agreed sum of $2,175,000 to release its obligation to deliver the balance of 17,313,454 pounds of contained nickel due under the contract. By reason of the present litigation (which was instituted on November 8, 1963) it was also agreed that if this action should result in a decree revising the ceiling price of 58.77¢ per pound downward in accordance with the Government's prayer, the parties would consider such revision applicable to the termination payment,

and Hanna would repay the Government an amount equal to 17,313,454 times the difference between the contract ceiling price of 58.77¢ and the revised ceiling price (R 299; Pl Ex 3).

The Origin of the Litigation

The Government conducted regular audits of the smelting company's financial operations under DMP-50, with particular reference to the proper allocation of expenses as between capital expenditures and cost of production (R 208-211, 391-395). In July, 1961, following an examination of certain of Hanna's books and records and its accountants' working papers for 1960, the Government asserted that certain expenditures which had been charged to cost of production (and therefore included in the price of nickel charged the Government in succeeding quarters) should have been capitalized (R 211).

On March 14, 1962 the Government demanded reimbursement of $210,605, contending that several expenditures noted in the 1961 audit in that total amount had been improperly allocated to cost of production and included in the price of nickel paid by the Government. Since total deliveries under the contract exceeded 95,000,000 pounds in September, 1960 and the applicable amortization rate was determined as of January 1 each year, the cost of these items could not be amortized in the price of nickel, and the Government contended it had overpaid Hanna for nickel by the amount of their cost, regardless of the fact that additional capital advances were available under the contract (Def Ex 125; see also Pl Ex 23, p 1).[10] On July 13, 1962 Hanna received a

10. The Government contended that unexpended capital advances were not available for these expenditures, which had not been submitted for its prior approval (R 227, 228, 303-304).

demand for $252,147, which included the same items and an additional $41,542, which was claimed on the theory that the reduction in Hanna's 1960 production costs resulting from allowance of the Government's original claim should be reflected in a reduction of the agreed ceiling price of 58.77¢ per pound under Amendment 5, and that the Government was entitled to a refund of $41,542 for nickel delivered after March 31, 1961 (Pl Ex 23; R 211).

From August to December, 1962, the Government conducted a further examination of Hanna's books and records for the period January 1, 1955 to March 31, 1961. On January 28, 1963 the Government presented Hanna with an itemized bill for $1,739,328, asserting that expenditures in that amount for 284 items charged to cost of production should have been capitalized and should not have been included in the price of nickel charged the Government (R 211; Pl Ex 61). This figure was adjusted in minor respects, and in the supplemental pretrial order the Government's claim for the 284 items amounted to $1,738,598 (R 304). At the commencement of the second segment of the trial on July 20, 1965, the Government abandoned its claim to reimbursement for 68 items costing $346,222 on the advice of its "independent accounting consultant" (R 334, 378; July Tr 7, 37). This concession reduced its claim to $1,392,376.55 for 216 items, which had been charged by Hanna to cost of production as follows:

1955 -	$	42,631.63
1956 -		239,454.96
1957 -		559,317.03
1958 -		190,685.96
1959 -		135,800.04
1960 -		215,768.60
1961 -		8,718.33
	$	1,392,376.55

(R 378, 392; Pl Ex 170)

The issue is whether, under the terms of DMP-50, these items were properly charged to cost of production. The trial court held that they were properly so charged to the extent of $1,160,871. The remaining sum of $231,506 is not involved in this appeal.

APPENDIX D

Analysis of Contract Drafts

1. The Government's initial draft ("1st Discussion Draft") of October 13, 1952 (Pl Exs 176, 177) made no reference to generally accepted accounting practice or to "replacements or improvements." It contained no definitions and did not use the term "capital advance." Significantly, however, it provided that advances would be made for the "design, acquisition, installation and necessary rebuilding or modification of the facilities * * *" (Pl Ex 176, p 11). The word "modification" was omitted from Hanna's initial draft of November 24, 1952 (Pl Ex 138, p 6) and the succeeding drafts and does not appear in the final contract.

2. Hanna's initial draft of November 24, 1952 (Pl Ex 138) used the term "capital advances"[1] and provided that such advances should be available to "repair" the facility (at p 6), a provision which was thereafter removed at the Government's insistence (Def Exs 118, 120).[2] Hanna's definition of the facility in Article III (at pp 3-4) contained no reference to generally accepted accounting practice.

Article V, which provided for capital advances, provided that they would be made:

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1. In Article V, which became Article VI in the final contract. Article III of the draft ultimately became Article IV.

2. In the final contract, repairs are included in the definition of the "facility" (Art IV), but they could not be paid for with capital advances.

> " * * * (a) to construct, equip, design, rebuild and repair the Facility contemplated by Article III, and (b) for such replacements, additions, or improvements of the Facility which are deemed necessary or advisable by the Contractor during the period of this Contract and which, in accordance with generally accepted accounting practice, are capitalized. * * *" (at p 6

Both Article III and Article V of the draft gave the contractor discretion to acquire equipment for the facility. The provision in this draft authorizing "additions" to the facility to be paid for with capital advances was omitted from the later drafts.

3. Article V of Hanna's draft dated November 26, 1952 (Pl Ex 139), in its original typewritten form, was identical with the draft of November 24. It provided (at p 6) for capital advances

> " * * * (a) to construct, equip, design, rebuild and repair the Facility contemplated by Article III, and (b) for such replacements, additions, or improvements of the Facility which are deemed necessary or advisable by the Contractor during the period of this Contract and which, in accordance with generally accepted accounting practice, are capitalized."

By handwritten amendments to subsection (b), the word "additions" was deleted, the discretionary authority of the contractor to determine the necessity for capital expenditures was also deleted, and the reference to "generally accepted accounting practice" became physically separated from the provision for "replacements * * * or improvements" by the insertion of a catch-all provision covering other capital expenditures. As so amended, it provided:[3]

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3. In this and subsequent cases, handwritten deletions are indicated and handwritten additions are underscored.

" * * * (b) for such replacements, ~~additions~~, or improvements of the Facility which are ~~deemed~~ necessary or advisable ~~by the Contractor~~ during the period of this Contract, and (c) for such other acquisitions and which, in accordance with generally accepted accounting practice, are capitalized."[4]

4. On December 9, 1952, Hanna prepared draft definitions of "capital cost" and "cost of production" which referred to "generally accepted accounting principles" (P1 Ex 140). The drafts are not shown to have been used or even submitted to the Government, and the record is silent as to their significance.[5] It is likely that the definitions became unnecessary, because the uses to which capital advances could be put were described in Article VI and working capital advances were to be available for all other costs (Article VI(2)).

5. The next draft is that of December 15, 1952 (P1 Ex 141). This draft, in its typewritten form, incorporated the handwritten amendments to the draft of November 26. It was, in turn, modified by handwritten amendment to read as follows:

" * * * (c) for such other necessary ~~acquisitions~~ expenditures, and which, in accordance with generally accepted accounting practice, are capitalized."

(at p 7)

6. The last draft disclosed by the record is dated December 19, 1952 (P1 Ex 142). In its typewritten form, Article IV and

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4. Also by handwritten amendment, the various contract Articles were given the numbers they bear in the final contract.

5. The November 26 draft had noted that such definitions would be added. The notation was, however, deleted (P1 Ex 139, p 3).

Article VI of this draft did not affirmatively require the Governmen agreement to capital purchases, although provisions giving the contractor discretion to purchase them had been deleted from the draft of November 26. Consequently, Article IV of this draft was amended in handwriting to read:

> " * * * all equipment and facilities agreed to by the Gov't as necessary for such conversion * * *" (at p 4)

and Article VI 1(b) was amended in handwriting to read:

> " * * * (b) for such replacements and improvements of the Facility which are agreed by the Contractor and the Gov't to be necessary or advisable * * *"

Subparagraph (c), which in its typewritten form incorporated the amendments to the December 15 draft, was further amended in handwriting to read:

> " * * * (c) for such other necessary and so agreed upon expenditures, ~~and~~ which, in accordance with generally accepted accounting practice, are capitalized * * *"

7. Notes of the Government negotiators dated December 31, 1952 (Def Ex 122, p 3) disclose a dispute over the provision in the draft of Article VI for the capitalizing of all costs during "down periods" occurring before the end of Period 1, as follows:

> "We want to only capitalize such costs as are indicated by normal accounting practices * * *" 6

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6. The balance of the notation is illegible. On January 16, 1953, Colonel Robinson, the Government negotiator, noted the view that this provision was contrary to normal accounting practice, although Ernst & Ernst had rendered an opinion supporting it (Def Ex 83).